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Honorable Vernon A. Williams
Secretary
Surface Transportation Board
Case Control Unit
1925 K Street, N.W.
Washington, D.C. 20423-0001

Re: Ex Parte No. 582 (Sub-No. 1), *Major Rail Consolidation Procedures*

Dear Mr. Williams:

Enclosed for filing on behalf of Norfolk Southern Corporation and Norfolk Southern Railway Company ("NS") in the above-referenced docket are a signed original and 25 copies of the "Reply Comments of Norfolk Southern" Also enclosed is a computer disk containing a copy of this filing in WordPerfect 7/8/9 format.

We are also tendering herewith for filing an original and 25 copies of Volume II of a "Joint Compendium of Prior Railroad Submissions on Forced Access and Bottleneck Rate Issues." This Joint Compendium is being submitted jointly on behalf of NS, CSX Corporation and CSX Transportation, Inc. (jointly, "CSX"), and Union Pacific Corporation and Union Pacific Railroad Company (jointly, "UP"). (Volume I of the Joint Compendum is being filed separately by UP.) UP's submission includes a request for a waiver, to the extent applicable, of the requirement that the materials included in the Joint Compendium be submitted in electronic format.

Please acknowledge receipt of these papers for filing by date-stamping the enclosed duplicate copy and returning it with our messenger. Thank you for your attention to this matter.

Very truly yours,

Vincent F. Prada

G. Paul Moates
Vincent F. Prada

Enclosures
cc: All Parties of Record (w/encls.)

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STB EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

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REPLY COMMENTS OF NORFOLK SOUTHERN

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DATED: June 5, 2000

Page

GLOSSARY OF COMMENTING PARTY NAME ABBREVIATIONS

Abbreviation	Party Name
[illegible]	Association of American Railroads
[illegible]	American Forest & Paper Association
AG Processing	AG Processing Inc.
Ameren	Ameren Services Company
ARC	Alliance for Rail Competition
ASLRRA	American Short Line and Regional Railroad Association
BASF	BASF Corporation
BNSF	The Burlington Northern and Santa Fe Railway Company
Bunge	Bunge Corporation
Canadian Pulp	Canadian Pulp and Paper Association
Cleveland	City of Cleveland, Ohio
CMA	Chemical Manufacturers Association and American Plastics Council
CN	Canadian National Railway Company
Consumers	Consumers Energy Company
CP	Canadian Pacific Railway Company
CPUC	California Public Utilities Commission
CSX	CSX Corporation and CSX Transportation, Inc.
CURE	Consumers United for Rail Equity
DME	Dakota, Minnesota & Eastern Railroad Corporation

DOA	United States Department of Agriculture
DOT	United States Department of Transportation
Dow	Dow Chemical Company
DuPont	E. I. Du Pont de Nemours and Company
EEI	Edison Electric Institute
Farmrail	Farmrail System, Inc.
TFI	Fertilizer Institute
Finger Lakes	Finger Lakes Railway Corporation
IMPACT	Committee to Improve American Coal Transportation (Arkansas Electric Cooperative Corporation, Edison Mission Energy and Midwest Generation LLC, UtiliCorp United)
Iowa Traction	Iowa Traction Railroad Company
Kansas	Kansas Department of Transportation, Kansas Corporation Commission and Kansas Office of the Attorney General
KCS	Kansas City Southern Railway Company
Montana Wheat & Barley	Montana Wheat & Barley Committee, Colorado Wheat Administrative Committee, Idaho Barley Commission, Idaho Wheat Commission, Oregon Grains Commission, Nebraska Wheat Board, South Dakota Wheat Commission and Washington Barley Commission
MRL	Montana Rail Link, Inc., I&M Rail Link, LLC and Southern Railway of British Columbia
New York	State of New York
NGFA	National Grain and Feed Association
NITL	National Industrial Transportation League
NMA	National Mining Association

NRLC	National Railway Labor Conference
NS	Norfolk Southern Corporation and Norfolk Southern Railway Company
OG&E	OG&E Electric Services
Ohio RDC	Ohio Rail Development Commission
Oklahoma	Oklahoma Department of Transportation
Otter Tail	Certain Coal Shippers (Otter Tail Power Company, Public Service Company of Colorado, Southwestern Public Service Company, TUCO, Inc., Tucson Electric Power Company and Western Resources, Inc.)
OxyChem	Occidental Chemical Corporation and OxyVinyls, LP
Port Authority	Port Authority of New York and New Jersey
PPL	PPL Electric Utilities Corporation and PPL Montana LLC
RLD	Rail Labor Division, Transportation Trades Department, AFL-CIO
SPI	Society of the Plastics Industry, Inc.
Transition	Transition Corporation
UP	Union Pacific Corporation and Union Pacific Railroad Company
Wayerhaeuser	Weyerhaeuser Corporation
WCTL	Western Coal Traffic League, American Public Power Association, National Rural Electric Cooperative Association, Alliant Energy Corporation, Central and South West Services, Inc., City of Grand Island, Nebraska, City Utilities of Springfield, Missouri, LaFayette Utilities System, Northern States Power Company, Platte River Power Authority, Salt River Project Agricultural Improvement and Power District and Texas Municipal Power Agency
Williams	Williams Energy Services
Wisconsin Central	Wisconsin Central System

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

REPLY COMMENTS OF NORFOLK SOUTHERN

Pursuant to the Board's Advance Notice of Proposed Rulemaking ("ANPR"), served March 31, 2000, Norfolk Southern Corporation and Norfolk Southern Railway Company (jointly, "NS" or "Norfolk Southern") respectfully submit these reply comments on the issue of proposed modifications to the Board's policies and rules governing proposed major rail consolidation transactions.[1] These reply comments are supported by the attached Verified Statement of William J. Baumol.[2]

INTRODUCTION

The Board received opening comments from approximately 130 parties representing a broad spectrum of interests, including major railroads like NS, smaller carriers, shippers, rail employees, government agencies and officials and other parties. The comments included many constructive suggestions for improvements in the Board's policies and rules governing major rail

1 As in its opening comments, NS uses the term "merger" as a shorthand reference to all mergers, consolidations, acquisitions of control and other combinations, involving two or more Class I rail carriers, that are subject to Board review under 49 U.S.C. §§ 11321-11326.

2 Professor Baumol's statement was jointly commissioned by CSX, Norfolk Southern and UP, and may be separately submitted with the reply comments of the other sponsoring carriers.

consolidations. For example, many parties (including NS) urged the Board to apply more rigorous scrutiny of future major rail consolidation proposals by requiring a more persuasive showing that a proposed transaction will produce clear and substantial net public benefits, and to give much greater weight in the approval process to the effects of the transaction on rail service (both during and after the merger implementation period) and on the ability of the merged carriers to maintain and expand rail infrastructure and capacity. Many parties (including NS) also suggested that, because any future major rail consolidation proposal is likely to set in motion a process that will determine the final structure of the North American rail industry and potentially create a system comprised of two large, transcontinental railroads with lines extending beyond the U.S., the Board should revise its merger rules to ensure appropriate consideration of potential "downstream" and cross-border impacts and the preservation of effective rail competition (including shipper's existing routing options over major gateways). Many parties (including NS) also suggested useful changes in the Board's evidentiary requirements and procedures designed to improve the Board's decision-making process in major rail consolidation proceedings.

Unfortunately, the Board's ANPR also elicited numerous proposals that, in varying degrees, would be counterproductive or even dangerous to the future health of the rail industry and its ability to deliver safe, efficient and competitive rail service. Some parties, reflecting open hostility to the prospect of any further railroad consolidation, proposed various rules that would put onerous, in some cases virtually insuperable, evidentiary burdens and requirements on rail merger applicants. Other parties, viewing the likely prospect of further major rail consolidations as an opportunity to advance ulterior regulatory or commercial agendas, proposed instead to saddle future mergers with a host of burdensome requirements designed to remedy conditions that are unrelated to any genuine merger effects and, more broadly, to alter the fundamental principles of existing railroad economic regulation. If adopted, these proposals would increase unreasonably the costs of future rail mergers, deter even beneficial, efficient railroad consolidation proposals and, ultimately, prove a disservice to the public interest.

Prominent among these unsound proposals are the demands by numerous commenting parties that the Board use its revised merger rules to inject additional rail-to-rail competition through various forced or open access requirements, such as mandatory switching in terminal areas, compulsory trackage rights to permit two-carrier rail service to solely served shippers, "bottleneck" rate requirements and similar measures. As Norfolk Southern explained in its opening comments, these proposals should be rejected because they are not merger-related and because, in any event, they would contravene settled legal and economic principles and would do serious harm to the quality of rail service and the long-term viability of the railroad industry.

As an initial matter, these various proposals to "enhance" or "promote" rail-to-rail competition are not addressed to remedying adverse competitive effects of railroad mergers. They seek instead to alter the fact that most rail shippers are served by only one railroad -- a fact that has everything to do with market conditions (which in most cases cannot support two-carrier rail service at particular facilities) and virtually nothing to do with railroad mergers (which, due to competition-preserving conditions imposed by the Board and ICC, have not left otherwise dual-served rail shippers with only a single serving railroad). Precisely because the calls for additional rail-to-rail competition are not genuinely merger-related, there is no principled basis for the Board to limit such forced access. That is why many of the commenting shippers have declared that their forced access proposals should *not* be limited to the railroads involved in a merger proposal and that, indeed, to limit the open access relief to merger applicants would unfairly advantage shippers on the merger applicants over other shippers.[3] These arguments only highlight the point that demands for increased rail-to-rail competition and forced access are not related to the actual effects of proposed railroad consolidations. Forced access proposals raise significant policy issues that go far beyond the effects of rail mergers, and are matters that are appropriately addressed (if at all) by Congress, not by this Board, as several access proponents candidly acknowledged.[4]

Even if the calls for forced access were genuinely merger-related, the Board should reject these proposals because they are not authorized by law (as the Board has previously stated) and represent bad policy. Their only purpose is to reduce rates for so-called "captive" shippers and, thereby, to transfer revenues from the railroads to mostly large, economically powerful shippers. The only justification for such a revenue transfer is that solely served shippers pay higher rates than shippers served by multiple railroads. But this is as it should be under the system of differential pricing that virtually everyone agrees is necessary for railroad financial viability. Forced access measures would simply drive rates down toward variable cost (far below total costs), significantly increase the costs and complexity of the rail network (while degrading service) by requiring more switching and interchange, fragmenting traffic over additional routings

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3 *See*, *e.g.*, NITL at 11-18; CURE at 3-6; TFI at 6; PPL at 3, 8-10; DuPont at 4-5, 8-9; Dow at 3, 7-8; OG&E at 3-4; Otter Tail at 7-8.

4 *See*, *e.g.*, ARC at 6; CURE at 6, 14; DuPont at 11; Williams, O'Connor VS at 19; BASF, O'Connor VS at 14; Montana Wheat & Barley at 7. For this reason, Norfolk Southern does not agree with the suggestion by BNSF and CN that the Board sever these open access issues for separate consideration in a parallel rulemaking proceeding. BNSF at 3-4; CN at 4-5. NS also believes that, given the number and complexity of the proposals advanced in the opening comments, it would be imprudent for the Board to shorten significantly its planned schedule for the completion of this rulemaking.

and introducing costly dual operations over often busy rail segments. By reducing revenues and increasing costs, the forced access proposals would sap the rail industry's incentive and ability to invest.

Accordingly, Norfolk Southern strongly urges the Board to reject these extreme re-regulation proposals and to take a more balanced approach to the development of new rail merger rules. Future major rail consolidations may well be in the public interest, and make possible significant improvements in the quality and competitiveness of service to rail customers. Recognizing that possibility, the Board should not adopt a set of rigid or inflexible rules that will handcuff the agency and effectively preclude approval of major rail consolidation proposals otherwise beneficial to the public interest. Instead, the Board should focus on genuine merger-related impacts, leaving other ancillary issues to be resolved (if at all) through private-sector negotiations and, if necessary, through appropriate legislation. It is entirely appropriate for the Board to redefine the policy factors to which it will give significant weight in reviewing future major rail consolidation proposals, and to adjust its evidentiary requirements and procedures to focus on these policy factors. But the new merger rules should identify those policy preferences in a sufficiently flexible manner so as to encourage private-sector accommodations of competing interests and permit the Board to reconcile its varying policy considerations in deciding whether particular major rail consolidation proposals would be consistent with the public interest.

DISCUSSION

Given the large volume of opening comments submitted in this proceeding and the extremely short period for replies, Norfolk Southern will not attempt to respond to all of the many proposals and arguments presented during the opening round.[5] Instead, Norfolk Southern will focus on the issues it believes are most salient to the Board's reassessment of its rail merger rules and briefly explain NS's perspective on those issues.

I. GENERAL MERGER STANDARDS

As NS explained in its opening comments, it is entirely appropriate that the Board adopt new merger rules that "raise the bar" for approval of future major rail consolidation proposals. NS Comments at 8-12. In view of the current balanced structure of the rail industry, the possibility that inter-carrier alliances and coordinations may achieve at least some of the benefits of mergers, the serious (although relatively short-term) service disruptions experienced during the implementation of recent consolidation transactions, and the likelihood that any major rail consolidation proposal now would in all likelihood trigger another, probably final, round of rail mergers, the Board should scrutinize future major rail consolidation proposals more carefully and more skeptically. The Board should require a more persuasive showing that a proposed transaction would indeed have net public benefits that are tangible, significant and likely. The Board should also give more rigorous scrutiny to claimed merger benefits and merger-related service impacts, as NS and other parties have suggested.

It would be a serious mistake, however, for the Board to presume that further major rail consolidations -- including potential transcontinental mergers -- are unlikely to be in the public interest, or to incorporate in its revised merger rules any presumption (express or implied) against further major rail consolidations. It is too soon now to tell for sure, but additional rail

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[5] The Board therefore should not interpret NS's failure to respond here to a particular proposal or argument raised in the opening comments as indicating any acceptance or rejection of such position.

consolidations could well yield significant public benefits in the form of improved ability to compete with other railroads and other transportation modes, extension of single-line service, more efficient traffic routings, enhanced financial strength, and cost reductions (especially administrative and overhead costs). That has been the demonstrable experience of prior consolidations in the rail industry, notwithstanding the short-term service disruptions that have been experienced in implementing recent combinations. The dynamic and unpredictable nature of economic forces, including the fact that many of the railroads' customers and competing transportation modes are increasingly developing operations that are national (even global) in scope, makes it hazardous and inappropriate to assume that future rail consolidations are unlikely to produce significant efficiency and service benefits or to impose burdensome approval requirements based on such an assumption. *See* NS Comments, McClellan VS at 7.[6]

For essentially the same reason, the Board should adhere to its current approach of defining general policies and procedures in its merger guidelines, while leaving itself (and the parties) flexibility to refine and shape how those policies are applied based on the specific

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[6] In support of its claim that further end-to-end rail mergers are unlikely to generate significant public benefits, DOT cites a recently released study prepared by an economic consultant. DOT at 13 & n.7. Based on a statistical analysis of railroad financial reports, the study suggests that railroads do not enjoy increasing returns to scale from expanding the size of their networks. NS has not reviewed the data sources and statistical methodology used in the study, and thus cannot comment on the technical validity of the study's conclusions. The study, however, is confined to an analysis of factors affecting railroad costs, and does not address at all the non-cost, service aspects of end-to-end mergers, including the recognized preference for and desirability of extended single-line service. Nor does it address any other public benefits attributable to end-to-end mergers. The limited focus of the study is highlighted by its additional conclusion (which DOT neglects to mention in its comments) that *parallel* rail mergers -- which are objectionable because they involve clear reductions in rail-to-rail competition -- do yield public benefits and should be encouraged. (The study also confirms the need for railroads to engage in differential pricing, a finding that undermines the basis for DOT's mandatory switching and other open access proposals.)

transaction and record developed in an individual consolidation proceeding. NS Comments at 7-8. The Board therefore should not adopt specific rigid and inflexible rules, or pre-defined merger conditions, that would apply to all major rail consolidations regardless of the circumstances of a particular transaction. Major railroad consolidations are not susceptible to treatment as "cookie cutter" transactions. What is appropriate for one transaction, both in terms of evidence and conditions, may be inappropriate for another. The adverse effects of a particular transaction in one area may be outweighed by its beneficial impacts in other areas, requiring a balancing process that would be impossible if rigid rules were erected to prohibit the identified adverse effects. Neither the Board nor the parties can reasonably anticipate all issues that may arise in assessing the impacts of a future major railroad merger, and the Board's rules should be structured to allow the parties and the agency the room they need to tailor the sometimes competing public policy objectives to the circumstances of a particular transaction.

As a general matter, therefore, the Board should use this rulemaking to refine its merger policy statement to reflect the general policy objectives it seeks to promote through the merger review process, and to update its rules governing the procedural and evidentiary requirements for individual rail merger applications. The revised rules should specify general subjects that rail merger applicants will be expected to address and the categories of information they will be required to submit in their application. This approach should place the burden on the applicants to fashion testimony, merger impact analyses and commercial proposals that respond to the policy issues outlined in the rules. The adequacy of applicants' submission would then be subject to scrutiny by the Board and interested parties and weighed by the Board in the approval process.

For example, much concern has been expressed about the need for merger applicants to preserve major efficient gateways. The appropriate means of addressing this concern (which NS shares) is for the Board to include in its revised merger policy statement and rules provisions identifying the preservation of major gateways as a significant public interest consideration. The provision could direct applicants to conduct an appropriate analysis, and offer concrete proposals based on that analysis, that address this policy concern. The adequacy of the applicants' proposals (or any counterproposals advanced by other parties) would then be considered by the Board as one factor in its weighing of the public benefits and public harms of a proposed transaction. If the applicants' proposal is inadequate, that fact would weigh against Board approval of the transaction. This approach would place the burden on the applicants to come forward with proposals, and accommodations of competing interests, that address the Board's underlying policy concerns and that are workable in the circumstances of a particular case. This would encourage merger applicants to seek out negotiated, private-sector solutions to potential merger-related harms with affected parties.

II. DOWNSTREAM EFFECTS

Most commenting parties (including NS) agreed with the Board's preliminary determination to repeal its "one case at a time" rule and consider so-called "downstream" impacts of a proposed major rail consolidation. NS Comments at 51-52. Virtually every party agreed that rail merger applicants should submit evidence addressing the potential impacts of their proposed transaction on other rail carriers (including their ability to provide adequate service). However, the opening comments reflect uncertainty, and some difference of views, as to the appropriate scope of the downstream impacts analysis and the procedural mechanisms for considering such effects. The opening comments raised three issues in particular.

First, commenting parties expressed divergent views on the question whether the applicants or the Board should consider in a particular merger proceeding the impacts of possible downstream *transactions* (*i.e.*, proposed or hypothetical rail consolidations that the first transaction might induce). Some parties suggested that merger applicants should analyze the public interest effects of all possible responsive transactions (CSX), or at least the implications of a two-carrier rail system (UP), while others claimed that these requirements would be futile and burdensome (BNSF and CN).[7]

Norfolk Southern's position lies between these extremes. NS agrees that the impacts of downstream transactions should be an appropriate consideration in rail merger cases, but thinks that it would be impracticable to impose on merger applicants the difficult (if not impossible) burden of proving that hypothetical future rail mergers would not occur or that, if they did, they would be in the public interest. NS also does not believe that merger applicants should be required to shoulder the burden of predicting and justifying the final structure of the U.S. rail industry. But rail merger applicants should be required generally to address possible downstream impacts of their proposed transaction (including possible downstream transactions). More importantly, however, parties claiming that a particular proposed consolidation will have *adverse* (or beneficial) downstream impacts should be required to come forward with evidence identifying and supporting those claims, and the applicants should at that point be required to address those issues.

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[7] *Cf.*, UP at 4-5; CSX at 9-11 & App. G; CN at 16-28; BNSF at 13-16; CP at 7.

Second, a number of parties suggested in their comments that the Board should require consolidated proceedings with respect to separate major rail consolidations that are proposed relatively close in time.[8] Norfolk Southern agrees that consolidated proceedings could make sense in certain circumstances. Adoption of a specific rule requiring consolidation of separate rail merger proposals, however, could have unintended adverse effects. For example, if the Board adopted a rule requiring consolidation whenever a major rail consolidation is announced (through SEC filing or STB pre-filing notice) within 90 days after the filing of another merger application, parties could opportunistically game the system by timing their merger announcement to fall on the 89th or 91st day, depending on their preferences regarding consolidation. To avoid such tactics, the Board should retain discretion to order consolidation of separate proceedings. NS believes the Board already has ample authority in this regard, and that no specific rule change is warranted.

Third, various parties have suggested different measures the Board should or should not take to impose remedies for adverse downstream effects. Some have suggested that the Board can and should impose conditions on an earlier proposed transaction in order to remedy the adverse effects of later, even hypothetical transactions; others suggested that the Board should retain jurisdiction over an earlier transaction in order to impose retroactive conditions later if

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[8] *See, e.g.*, UP at 5; CSX at 9; CP at 7-8; DOT at 36; NGFA at 6; Wisconsin Central at 13. Other parties suggested that merger applicants be required to supplement their application with evidence addressing the effects of other merger proposals announced during the first proceeding. *See, e.g.*, BNSF at 15.

necessary in light of subsequent transactions; while other parties suggested that the Board lacks authority to impose conditions to remedy adverse downstream effects.[9]

Norfolk Southern believes that it is unnecessary for the Board to address these kinds of remedial issues in its revised merger rules. The issues are likely to turn on the specific circumstances of a particular claimed impact, and are not susceptible to resolution by general rule. As a general matter, it is not clear what circumstances might make it appropriate for the Board to burden one merger transaction with a remedial condition designed to ameliorate the adverse effects of another, subsequent transaction. And, as a policy matter, the Board should look with extreme disfavor on proposals to impose new conditions retroactively on already consummated merger transactions, which could raise serious due process and other legal issues. On the other hand, circumstances might well warrant the Board imposing a qualified condition in one merger proceeding to remedy adverse effects that would be realized only in the event that some other, later rail consolidation were to be completed. However, these questions can and should be addressed when and if they arise in a specific factual context. Given the breadth of the Board's conditioning authority, there is no need here for the Board to adopt a new rule on this subject.

III. MERGER-RELATED PUBLIC INTEREST BENEFITS

Norfolk Southern and numerous other parties suggested in their comments that the Board should examine more rigorously merger applicants' claims of transaction-related public benefits. In particular, it was suggested that applicants should be required to show that the particular merger-related public benefits they are claiming likely could not be achieved through inter-carrier coordinations, alliances or other measures short of formal merger. NS Comments at

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9 *See*, *e.g.*, CP at 8; Iowa Traction at 2-5; Port Authority at 10; CN at 21.

12-16. Some parties have complained that this sort of rule would impose on merger applicants the impossible task of proving a negative.[10] As Norfolk Southern explained, however, the Board's existing rules already generally require that the claimed benefits considered in the public interest balancing process must be genuinely merger-related. Thus, the proposed new policy would involve only a change (albeit a significant change) in emphasis, to make clear that this issue will be scrutinized more carefully in future rail consolidation proceedings, and that assertions that claimed benefits could not be achieved without a merger will require more detailed supporting evidence. Whether particular claims of merger benefits should be considered in the Board's public interest determination is a question that should be decided in individual cases.

Without question, the Board should scrutinize more rigorously in future cases claimed merger-related public benefits, and should monitor how approved transactions are implemented. Some parties, however, would go beyond this and impose truly draconian requirements on rail merger applicants to achieve the specific merger benefits projected in a rail consolidation application, to do so within the specific time frame outlined in the application and to bear various types of penalties if claimed merger benefits are not realized. Some parties would even disqualify a railroad from proposing a major rail consolidation application unless or until it achieved all of the promised benefits of prior approved consolidations.[11]

As Norfolk Southern explained on opening, these sorts of proposals are misguided, and fail to account for the way merger benefits estimates are developed in rail consolidation proceedings. Claims of merger benefits presented in a consolidation application represent good-

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[10] *See, e.g.*, CN at 39-45.

[11] *See, e.g.*, NITL at 9-10; SPI at 12-13; PPL at 13-15; Ohio RDC at 10.

faith estimates or projections of the beneficial impacts of a proposed consolidation. Typically, they are based on traffic studies and an operating plan that are predicated on traffic data for a prior, "base" year. The studies also reflect a static "before and after" analysis that seeks, deliberately, to factor out the effects of other economic conditions that affect railroad operations and financial performance. NS Comments at 13-14. But the actual implementation of a railroad consolidation never takes place during the "base" year. It necessarily occurs at some subsequent time, when the volume, mix and routing of freight traffic may be decidedly different than they were in the "base" year. And railroad operations and performance are deeply affected by a host of real-world economic conditions that vary over time and that are not reflected in the static impact analyses presented in rail merger applications.

For these reasons, claimed merger benefits might not be achieved in the same manner, to the same extent or on the same timetable as claimed in a merger application. The Board should therefore require sound merger benefit estimates and take reasonable measures to ensure that applicants seek to achieve them, but the agency cannot realistically impose on rail merger applicants an absolute requirement that they achieve perfection in realizing claimed merger benefits. Even if the Board were inclined to hold applicants to such a standard, it would be an almost impossible task for the Board, after the fact, to unravel a merged system's post-consummation operations and financial performance to determine whether claimed shortfalls (or overages) in merger benefits are attributable to applicants' own failures or to exogenous business conditions over which applicants have no control.[12]

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[12] Imposing a rule that railroads could not be involved in a major rail consolidation if they have failed to deliver fully the promised benefits of a prior merger would make no sense. In (continued...)

It is an understandable desire by many parties to have absolute, iron-clad certainty that a proposed major rail consolidation as implemented will conform precisely to the public benefits and other claims set forth in the rail merger application. But the reality is that certainty is impossible and attempting to enforce the impossible through penalties and other adverse consequences is unrealistic and counterproductive. Projections or estimates of merger benefits are just that. They should be reasonable and reflect good-faith analysis and judgment. The Board should scrutinize them carefully and decide whether to approve a proposed consolidation on the basis of the best evidence it has before it at the time of decision. The Board should also monitor the implementation of approved transactions and the extent to which the carriers are actually achieving public benefits (which may or not be the benefits originally projected in the carriers' rail consolidation application).

IV. SAFEGUARDING RAIL SERVICE

In light of the regrettable service problems the railroad industry (including NS) has experienced during recent major rail consolidations, it was no surprise that safeguarding rail service (particularly during merger implementation) emerged as a major issue of concern in the opening comments. Norfolk Southern fully agrees, and suggested that the Board revise its merger policy statement to make clear that the effects of a proposed major rail consolidation on the adequacy of service to rail customers -- both during the short-term merger implementation period

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[12](...continued)
effect, it would impose a double penalty on shippers -- first through the failure to achieve the claimed public benefits of the first transaction and second through the denial of the potential benefits of a later transaction. If the later transaction would benefit shippers and the public, there is no reason not to approve it and allow those benefits to be realized, whether or not some prior transaction fell short of its claimed benefits.

and over the longer term -- will be treated as a primary public interest consideration In that regard, rail merger proponents should be required to make a particularly strong showing of positive, merger-related service impacts as a prerequisite to approval of a proposed combination NS Comments at 17-18.[13] Major rail consolidations should result in better, not worse, service to rail customers. It is therefore entirely appropriate for the Board to impose on merger applicants an affirmative duty to show that their proposed combination will materially improve the overall level and quality of service provided by the merged system.[14]

No commenting party expressed disagreement with the notion that the Board should give closer scrutiny to merger-related service impacts. The opening comments reflected a wide variety of views on two broadly defined sets of issues relating to service The first involves the proper mechanisms for assessing (and monitoring) the service impacts of a proposed rail merger. The second involves the issue of remedies for merger-related service deficiencies

A. Assessing Rail Service Impacts

Most commenting parties (including NS) suggested that the Board should require rail merger applicants to submit as part of their merger application an assessment of the service

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[13] The quality of rail service is, over time, heavily dependent on the adequacy of rail infrastructure and capacity. Thus, NS's proposal to accord greater weight to service impacts in the Board's merger review process embraces the issue of a proposed transaction's effects in facilitating investment in needed infrastructure and capacity. NS Comments at 24-26.

[14] It bears repeating that the Board's assessment of the service impacts of a proposed major rail consolidation should focus on system-wide effects as a whole, and not on the impacts of particular shippers viewed in isolation. No major rail consolidation can reasonably be expected to produce significant service benefits for every single one of the thousands of individual shippers served by major rail carriers. Some shippers may enjoy greater benefits than others, some may reap no benefits at all and some may even experience a diminution in service What should matter for merger review purposes is the combined impact of the proposed transaction on the affected shippers as a group. *See* NS Comments at 18-19 n.13.

impacts of their proposed transaction and a description of how service will be safeguarded during the merger implementation process. NS Comments at 19-20. Variously described as service integration plans, merger implementation plans or service transition plans, the common thread running through these various proposals is that merger applicants should be required to present, as part of their merger application, a written plan that, among other things, would:

(1) Assess the existing, pre-merger level of service provided to shippers;

(2) Describe how the proposed transaction would affect that pre-merger service performance;

(3) Analyze the adequacy of existing and proposed new rail infrastructure and equipment to accommodate existing and projected post-merger traffic volumes;

(4) Detail how the proposed consolidation would be implemented and how implementation plans would affect service levels;

(5) Identify major areas of potential implementation problems that might adversely affect service;

(6) Describe whatever contingency plans the applicants have or would put in place to remedy merger-related service problems if they were to arise;

(7) Outline the process the applicants will follow in communicating information concerning implementation and service integration to affected customers and other interested parties; and

(8) Describe whatever remedies would be applied in the event that unanticipated service difficulties arise.

Norfolk Southern supports the proposal to require submission of implementation plans. It is, however, critically important for the Board to delineate clearly the appropriate purposes, scope and uses of such information in proceedings before it. Unlike the operating plan submitted as part of every rail consolidation application, the implementation plan should not contain a static analysis of service impacts based on data for an arbitrarily defined, prior "base" year. If it is to have any real value in safeguarding rail service during actual implementation of an approved rail merger and assistir all interested stakeholders in ensuring successful merger implementation, the implementation plan must be treated as an evolving, organic document, which is continually revised and updated as traffic and market conditions change, merger implementation proceeds and unanticipated developments or problems surface. The implementation plan is a guide for the applicants as they proceed to implement an approved consolidation. Realistically, it should become more detailed and precise as the merger review and implementation process moves forward. The plan should be submitted as part of the merger application and subjected to public scrutiny during the course of the Board proceedings (including post-consummation oversight proceedings), but the primary focus of the Board's procedures should encourage (indeed require) the plan to be refined and modified in light of give-and-take between applicants, on the one hand, and the Board and its staff, on the other.[15] The incorporation of informal, non-adversarial procedures to review and refine such merger implementation plans could enhance the planning process and its success in facilitating smooth implementation of an approved rail consolidation. Most important of all, the requirement of a service integration or merger implementation plan

[15] Several parties suggested that the Board might consider the retention of outside consultants or a panel of experts to review applicants' merger implementation or service integration plans, either to provide feedback to the applicants or to assist the Board in its review of merger-related service impacts. *See, e.g.*, CSX at 12-13, Finger Lakes at 3 & Smith VS at 8-9. NS believes this is a matter that should be left to the Board's discretion in future cases as circumstances (including the adequacy of the Board's internal agency resources) warrant. Until the Board develops experience in reviewing implementation plans of the type described here, it will not be in a position to assess the need for outside assistance. For this reason, it would not appear sensible at this early juncture to institutionalize the appointment of outside consultants in the Board's revised merger rules.

should always leave railroads with the freedom they need to respond immediately to emerging service problems with necessary changes in operations, regardless of the plans described in their formal written submissions to the Board.[16]

Given these salutary purposes, the proposed implementation plans should not be regarded as establishing binding, unchangeable commitments by the merger applicants. The implementation plan should be used to help guide and monitor merger implementation and its effects on service. If initial plans are treated as binding commitments with enforceable penalties for non-compliance (as a number of parties have suggested), however, the plans will never effectively serve their intended function and, most importantly, will be counterproductive and not in the public interest as the inflexibility generated by such plans would have the very likely effect of impairing and degrading service for a large number of rail shippers.

It is also important that the rules requiring the submission and review of a service integration or merger implementation plan be sufficiently flexible so as to permit individual railroads to develop appropriate types of service-impact data and information that are realistically within their ability to produce and that can be tailored to the needs of a particular transaction. The Board should reject a rigid, "one size fits all" approach. It should instead follow the approach of the agency's existing regulations prescribing the preparation of operating plans and

[16] Responding to unanticipated service problems, whether or not related to the implementation of a merger, typically requires prompt and decisive action by a railroad. The merger implementation process therefore must not become so burdened by administrative requirements that railroads would be prevented from taking unilateral action to remedy service problems in their incipiency. A railroad must be able to react to forces which adversely affect service, whether or not they are merger-related. Indeed, many of the factors that cause railroads to make daily adjustments in their operations -- weather, strength of harvests here and abroad, environmental law changes, global economic conditions, changes in production schedules of rail customers, etc. -- have nothing to do with railroad consolidations.

other impact analyses and include in its revised merger rules a description of the general subjects the applicants should address in their merger implementation plans and the general categories of information and data they should include with the plans rather than a catalog of detailed evidentiary requirements.

One specific area in which this kind of flexibility is very important relates to quantitative service performance measures (or "metrics"). A number of parties expressed dissatisfaction with the service performance metrics the Board has required railroads to submit in recent rail consolidation transactions, including the data NS and CSX regularly submit to the Board in connection with its oversight of the Conrail transaction. Specifically, some commenters claim that aggregated data is unhelpful to shippers seeking to assess the railroads' service levels for particular traffic movements or in particular traffic corridors, and that merger applicants should therefore be required to develop and present, both for some defined pre-merger "base" period and thereafter throughout the Board's merger review and oversight process, more individualized metrics such as individual shipment transit times, cycle times or car supply performance.[17]

Imposing a requirement that rail merger applicants develop and submit such specific, individualized service metrics would be unworkable in practice and competitively objectionable as well. As the Board and its staff will recall, the development and implementation of the necessary data systems to produce reliable service metrics for the Conrail transaction required extensive effort and negotiation. Railroads have widely divergent and often incompatible

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[17] *See, e.g.*, UP at 6-7; NITL at 19; CPUC at 6; Finger Lakes, Smith VS at 16-18; NMA at 3-5; DuPont at 7-8; Williams, O'Connor VS at 57-58; PPL at 11-12; Transition at 10-11; NGFA at 9.

systems for measuring train and car movement and overall service performance. Some carriers may have systems in place to capture reliable dock-to-dock transit or cycle times; others do not. And carriers invariably measure these statistics differently, with data systems that measure arrival and departure times differently, that exclude time associated with various functions in different ways, and similar variations.[18] This means that, even if two railroads proposing to merge both have the capacity to produce shipment-specific or corridor-specific service performance metrics, their systems may not be compatible with each other and therefore cannot be combined to produce consistent results. All of this suggests that the Board should avoid the prescription of detailed rules specifying the type of service performance metrics to be used in future rail consolidation cases. Rather it should allow parties to work through the difficult data issues and develop appropriate accommodations in individual cases.[19]

The required generation and submission in merger proceedings of shipment-specific transit time, cycle time or other service performance measures would also raise serious confidentiality and competitive issues. The routine disclosure of such information would permit shippers to obtain commercially sensitive data about their direct competitors. *Cf.*, 49 U.S.C. § 11904 (prohibiting disclosure of shipper-specific data). For this reason, several parties urged the Board to require more aggregated service metrics data, such as for broadly defined traffic

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18 One party that has proposed a rule requiring more precise service performance metrics (UP) candidly admitted that it does not have the ability reliably to measure what its rule would require railroads to submit. UP at 7 (car supply data).

19 Developing realistic service performance metrics obviously requires an accommodation among competing objectives, including the relative costs and time that might be entailed in developing systems to track movement-specific service performance.

lanes or corridors.[20] Norfolk Southern agrees with these concerns. Thus, while NS would support efforts (such as the CSX proposal mentioned in NITL's comments) (NITL at 19) to develop systems to generate accurate, comparable service performance measures on a corridor-specific basis, these efforts must necessarily be linked to particular major rail consolidation proposals and should not be prescribed in detail in the Board's revised merger rules.

B. Remedies for Merger-Related Service Disruptions

The opening comments included a broad array of proposals to require applicants in major rail consolidation proceedings to "guarantee" that rail service will not be disrupted as a result of a proposed combination (particularly during the implementation process) and to "indemnify" or compensate shippers (and short-line railroads) for all damages and losses associated with serious service failures. Many parties also proposed various new remedial mechanisms to enforce such "guarantees," including the creation of new Board-administered damages and access remedies, binding expedited arbitration and mediation.

As Norfolk Southern explained in its opening comments, these proposals to impose new mandatory remedies for merger-related service failures are counterproductive and misguided, and should not be adopted. NS Comments at 20-24. Rather than repeat that discussion here, Norfolk Southern would emphasize several important points.

First, although Norfolk Southern appreciates the understandable desire by various shipper and short-line interests to use regulation to insulate them from merger-related service disruptions, the proposed remedies cannot ensure that service disruptions will not occur. Norfolk Southern can speak from first-hand experience in this regard. Despite what ranked as among the

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20 *See*, *e.g.*, NGFA at 9.

most elaborate merger implementation planning efforts ever undertaken, NS (and CSX) experienced service disruptions in the early implementation of the Conrail transaction. NS had every incentive to minimize or prevent service disruptions, including the prospect of significantly increased costs, lost business and other consequences of service problems.

Second, existing law already furnishes remedies for serious rail service deficiencies, and these remedies are adequate to protect the interests of affected rail shippers and other parties. These remedies include civil damages actions and temporary access remedies before the Board.

Third, the creation of new remedial mechanisms before the Board (as some parties have proposed) would be counterproductive. The Board has neither the experience nor the resources to become a catch-all claims adjudicator. These matters are better left to the courts or to arbitral remedies provided under individual rail transportation contracts.

Fourth, requiring mandatory service "guarantees" and compensation for merger-related service failures would also circumvent privately negotiated resolution of service disputes. Norfolk Southern has had its share of experience in handling such disputes. It has been able to work out, to the mutual satisfaction of both parties, negotiated solutions of rail service disputes with most complaining shippers, usually without resort to litigation. In the process, Norfolk Southern has agreed in some cases to compensate affected shippers for the costs of alternative transportation and to modify rail transportation contracts, and has offered numerous rate, service and other commercial concessions to resolve significant, legitimate claims of service deficiencies. It is unlikely that these efforts would have been successful if shippers had easy resort to automatic "guarantees" and damages remedies.

A number of commenting parties have proposed that shippers be entitled to obtain compensation for all direct and indirect injuries suffered as a result of merger-related service failures, including imposition of liability for consequential damages. To take account of such potential liability (which railroads do not bear under current law), and recoup these costs, railroads would have to adjust the rate levels they charge. Current rate levels simply do not reflect the costs of potential liability for consequential and special damages. The rate levels railroads charge today do not reflect the risks (and costs) of such consequential damages claims, which can be enormous and unforseeable. It is therefore wholly inappropriate for the Board to impose such liability as a condition to approval of a proposed rail merger. Shippers seeking a guarantee against possible consequential injuries from merger-related service interruptions should secure such protection through negotiations with individual railroads, and payment of rate levels that reflect the risks (and potentially enormous costs) of such liability, or through the purchase of insurance.

Although Norfolk Southern firmly believes that mandated service guarantees and creation of new remedial mechanisms for merger-related service disputes would be unsound as a matter of law and policy, NS is sensitive to the need for rail merger applicants to provide shippers and other affected interests greater assurances that proposed major rail consolidations will not result in service disruptions. The Board's revised merger rules should not dictate specific requirements for service assurances, but rather should identify such assurances as an important public interest factor the Board will consider in the merger review process, leaving it to the merger applicants in the first instance to come forward with concrete proposals for assuring rail service. This approach would signal to future rail consolidation applicants that their failure to develop workable proposals for assuring rail service and remedying unanticipated service problems will be regarded as a factor weighing against approval of their proposed merger. But it allows the merger applicants in the first instance to weigh the competing considerations and to fashion an acceptable proposal for assuring rail service levels. In short, the Board should adopt a policy encouraging effective merger implementation and service integration plans and voluntary remedies for merger-related service failures, but should not mandate specific outcomes or prescribe new remedial devices that might well have the effect of discouraging otherwise beneficial rail consolidation proposals.

V. COMPETITIVE EFFECTS

Most commenting parties devoted substantial attention in their opening comments to the issues of merger-related competitive effects and rail-to-rail competition generally. Comments were addressed to two broad, but analytically distinct, sets of issues: (1) whether the Board's competitive-impact standards adequately ensure that proposed rail consolidations will not reduce effective rail-to-rail competition, and (2) whether the Board should abandon long-established legal precedent and use its merger review process not only to preserve but to "enhance" or "promote" rail competition through various types of open or forced access merger conditions.

A. Preserving Rail-to-Rail Competition

Many commenting parties voiced dissatisfaction with the standards the Board has followed in deciding whether a proposed rail consolidation unreasonably diminishes effective rail competition. These comments focused on (1) "three-to-two" issues, (2) the "one-lump" doctrine, and (c) other vertical effects issues such as the maintenance of efficient gateways. With the exception of the last of these issues, no changes are warranted in the Board's current treatment of these competitive-impact questions.

1. "3-2" Issues

In recent rail merger proceedings, the Board and ICC have generally concluded that a merger-related reduction from three to two in the number of independent railroads serving particular shippers would not result in a diminution of competition sufficient to warrant the imposition of remedial conditions. While a number of commenting parties strenuously disputed the validity of the Board's prior findings on this issue, and urged the Board to impose remedial conditions in all "3-to-2" situations,[21] others noted that future major rail consolidations are unlikely to involve any significant number of shipper facilities that enjoy three or more viable, competitive rail options,[22] and that the Board should address any such claims of competitive harm on a case-by-case basis.[23] Norfolk Southern agrees. NS Comments at 32-33. Three-to-two issues have always been considered by the agency on a case-by-case basis, and there is no reason to change that approach.[24]

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[21] *See, e.g.*, SPI at 6-9; PPL at 22-23; EEI at 4; Williams, O'Connor VS at 59; OxyChem, O'Connor VS at 53; NGFA at 13-14; IMPACT at 19-25; Ameren at 5-6.

[22] *See, e.g.*, DOT at 16-17; NITL at 11; DuPont at 9-10; Dow at 16-17; CMA at 22; PPL at 22.

[23] *See, e.g.*, DOT at 16-17; BNSF at 29; CN at 31-33; UP at 16-17; CP at 13-14; Wisconsin Central at 12; WCTL at 25-26.

[24] A few parties took the position that the Board should not allow *any* reduction in the number of rail options available to a particular shipper, whether it receives pre-merger service by two, three or even ten railroads. *See, e.g.*, KCS at 5-21; Kansas at 13. The number of situations in which a shipper enjoys effective rail service by four or more independent railroads is extremely small. Claims of merger-related reductions in competitive rail options in such cases should also be (continued...)

2. "One-Lump" Doctrine

Many commenters representing shipper interests urged the Board to abrogate its "one-lump" doctrine, which provides that, in the absence of contrary evidence, an exclusively served rail shipper does not suffer competitive harm when the serving railroad merges with a connecting rail carrier in a purely vertical, or end-to-end combination.[25] As Norfolk Southern has explained, however, the doctrine is supported by well-established economic principles and has been sustained by the courts. NS Comments at 33-34. Moreover, the doctrine erects no insuperable barrier to the assertion of claims of anticompetitive vertical foreclosure, but simply requires shippers to present plausible evidence demonstrating that a railroad which provides exclusive rail service to a particular shipper enhances its ability to charge supracompetitive rates by combining with a competitive downstream carrier. Despite several opportunities, no shipper has offered any concrete evidence successfully challenging the validity or application of the "one-lump" theory.[26] There is, therefore, no reason for the Board to abandon it. Issues of claimed

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[24](...continued)
considered on a case-by-case basis.

[25] *See, e.g.*, ARC at 2-3; SPI at 6, 16; NITL at 5-9; PPL at 19-22; WCTL at 25-26; Otter Tail at 9-10; EEI at 4-5; Consumers at 5-7; Ameren at 4-5; IMPACT at 25-26; Dow at 3-7.

[26] Several parties claim that testimony submitted by protesting shippers in the recent Conrail transaction proved the invalidity of the "one-lump" doctrine. *See, e.g.*, ARC at 3; EEI at 5. Far from it. NS and CSX demonstrated in that case that the shipper testimony was based on flawed assumptions and inaccurate data, and thus failed to demonstrate any basis to conclude that solely served shippers benefitted from pre-merger downstream rail-to-rail competition. *See* STB Finance Docket No. 33388, CSX/NS-176 at 80-93; CSX/NS-177 at 252-82 (Kalt VS). The Board agreed with NS and CSX and rejected the shippers' claims. STB Finance Docket No. 33388, *CSX Corp. -- Control & Operating Leases/Agreements -- Conrail Inc.*, Decision No. 89 (served July 23, 1998), at 67-70.

adverse end-to-end competitive impacts should continue to be considered in individual cases on the basis of specific claims and evidence.[27]

3. Maintenance of Efficient Gateways

In recognition of the possibility of future major rail consolidation proposals that would create transcontinental rail systems, many parties have expressed increased concern about the potential closure of efficient gateways for the transfer of interline freight traffic. As NS explained in its opening comments, these concerns are largely unfounded. There are today only a handful of commercially significant interchanges between the major Class I railroads, reflecting the consolidation of freight traffic flows over the most efficient, high-density routes. These established, efficient gateways are unlikely to be closed as a result of a major rail consolidation. Nevertheless, because the issue of gateway closures has assumed such significance in light of the current structure of the industry, NS suggested that the Board's revised merger policy should include provision for the maintenance of major, efficient gateways. NS Comments at 34-39. Many commenting parties urged the Board to keep gateways open,[28] while most railroads (like

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[27] Some commenting parties complained that an end-to-end merger, by extending the length of a bottleneck rail segment, might reduce shippers' rights to separately challengeable rates under the so-called "contract exception" to the general rule that the reasonableness of railroad rates must be tested only for the entire end-to-end through movement between origin and destination. *See, e.g.*, NITL at 16-18; Dow at 4-6. Norfolk Southern agrees that the Board should impose conditions in future merger cases to ensure that otherwise available relief under the "contract exception" is not eroded as a direct result of a railroad merger.

[28] *See, e.g.*, DOT at 13-14; NITL at 15-16; TFI at 4-5; SPI at 9; DOA at 16; EEI at 4; PPL at 23; DuPont at 8; Dow at 7; Williams, O'Connor VS at 47-48; NGFA at 10-11.

NS) acknowledged the need for some sort of gateway preservation measures, and some offered concrete proposals similar to that presented by NS.[29]

Thus, there is widespread consensus that the Board should adopt a policy promoting the maintenance of efficient gateways in major rail consolidation proceedings. In this area, as in others, the soundest approach is for the Board to identify major gateway preservation as an important policy objective and place the burden on merger applicants to come forward with a specific proposal to meet that objective. NS described in its opening comments one such proposal for preserving major efficient gateways. NS Comments at 37-39. Under this proposal (which is similar to the rule proposed by UP and Williams),[30] merger applicants would be required to keep open major, commercially significant gateways (such as the major Midwest and Mississippi River interchanges) through a commitment to establish, upon request of a shipper, common carrier or contract rates to apply to the post-merger movement of traffic over the covered gateways in conjunction with another railroad serving the gateway. Absent agreement of thc connecting carrier to a joint rate, the merger applicant would be required to establish a separately challengeable common carrier rate applicable to its service to/from the gateway, leaving the shipper free to negotiate with the connecting carrier on a rate to complete the interline movement.

Norfolk Southern's suggested approach would effectively preserve shippers' pre-merger competitive options to use either of two connecting rail carriers serving a major, efficient gateway. It would prevent major rail mergers from having the effect of extending the reach of so-

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[29] *See, e.g.*, UP at 10-14; BNSF at 22-24 & App. A-5; CN at 33; CSX at 20-23; CP at 14-15.

[30] *See* UP at 10-14; Williams, O'Connor VS at 47-48.

called "bottleneck" rail segments It reflects a reasonable accommodation of the competing desires to preserve shipper routing options while maintaining the railroads' ability to promote efficient routes and exploit the economies of expanded single-line service. And it avoids the disastrous inefficiencies of the discredited regime of *DT&I* gateway conditions, which required railroads to keep open virtually all gateways (however inefficient) and undermined genuine rail-to-rail competition by freezing through rates over competing routes.[31] NS's approach would be enforceable through the workable arrangement of requiring (if necessary) a merger applicant to quote a separately challengeable rate to apply to its portion of interline service over the covered gateway. NS urges the Board to give this proposal consideration, although the details of the measure -- including identification of the specific gateways and shippers covered by it -- should be left for determination in individual rail consolidation proceedings.[32]

In making determinations in individual consolidation cases about which gateways the applicant carriers should be required to keep open, the Board should remain mindful of the

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[31] Several commenting parties suggested that the Board should require the maintenance of open gateways through imposition of various sorts of arbitrary rate caps for joint-line movements or introduction of Board scrutiny of "commercial closing" issues. *See, e.g.*, SPI at 8-9; AG Processing at 6-7; NGFA at 10-11, Bunge at 7-8. These proposals are administratively unworkable, would contradict the Board's maximum rate standards and would embroil the Board and the parties in policing equality of rates over competing joint-line routes, with all of the attendant inefficiencies of the old *DT&I* conditions and the "commercial closing" doctrine.

[32] Norfolk Southern thus agrees that the Board's revised merger rules should address the potential effects of future major rail consolidations in closing efficient gateways. Some commenting parties, however, seek to impose on merger applicants a requirement that they also reopen any previously closed interchange upon request of a shipper. *See, e.g.*, DOA at 16; EEI at 4; PPL at 23; Dow at 7. These proposals are not addressed to ameliorating the effects of proposed rail mergers, but instead seek to restructure existing rail operations. That alone provides sufficient reason to reject these proposals. The proposals are, in any event, unsound as a matter of policy. They would re-introduce the system of mandated open routings and inefficient traffic flows that almost destroyed the railroad industry.

importance of not dictating establishment of new gateways, as opposed to ordering maintenance of existing gateways which handle significant amounts of traffic. As the Board understands, railroads have established particular gateways for the interchange of traffic based on real-world considerations of economy and efficiency. All things being equal, railroads are entitled to their long hauls, especially for originating shipments (*see* 49 U.S.C. § 10705(a)(2)), and that economic reality, coupled with the carriers' mutual incentive to establish efficient physical interchange operations, explains the location of existing interchanges for major traffic flows. Efforts to impose by regulatory fiat locations for mandatory interchange -- including adoption of a rule providing shippers the ability to seek imposition of conditions on mergers requiring the establishment or maintenance of gateways in locations that the interchanging carriers themselves have not selected -- should be avoided. The current major gateways reflect a balancing of revenue, cost and service issues between *both* of the connecting carriers, which government regulation could easily upset.

B. Attempting to Inject New Rail-to-Rail Competition Through Forced Access

The Board and the ICC for many years have followed a consistent policy of preserving existing rail-to-rail competition in rail mergers, without attempting to "enhance" rail-to-rail competition or create new competitive rail options where they did not previously exist. This approach is in accordance with law and precedent, and has been approved by the courts. Notably, the consistent application of this policy by the Board and the ICC in all major rail consolidation proceedings during the past decade has ensured that no shipper previously receiving direct service from two or more railroads has become "captive" to a single railroad as a result of a merger.

In this proceeding, however, a number of shippers have claimed that prior mergers have left the rail industry less competitive than it was many years ago. This claim is demonstrably false. While there are indeed fewer Class I railroads, they compete more intensely over broader geographic regions than ever before. No shipper has been deprived of multi-carrier rail service as a result of the rail mergers and consolidations of the past decade, and shippers overall have benefitted enormously from the larger carriers' ability to offer extended single-line service that permits freight to move more efficiently, and more competitively, across greater distances than ever before, and significant capital investment in new rail infrastructure. The extended reach of larger railroads has permitted them to compete more effectively with trucks and other modes, as well as with each other, offering shippers more competitive transportation options. Thus, prior rail mergers have produced more competition, not less.

Despite this successful history, the Board has requested comment on whether it should abandon its time-tested policy of preserving existing competition in rail mergers, and instead adopt a new policy of "enhancing, rather than simply preserving, competition." ANPR at 7. This potential policy change has attracted considerable attention, but little agreement. Shippers who expect to receive a financial windfall from this potential change in policy have rushed to embrace it (and to propose more extreme measures), while railroads (including Norfolk Southern) have opposed the proposal for a number of important reasons. *See* NS Comments at 39-51; AAR at 2-8 & Rockey VS.

Among other things, shippers have proposed to implement this policy shift through the adoption of mandatory open switching in terminal areas (thereby overruling the *Midtec* decision),[33] mandatory establishment of separately challengeable rates over bottleneck segments (thereby overruling the *Bottleneck* decision),[34] compulsory grants of trackage rights for the benefit of shippers now served by a single railroad and other forced access proposals.[35] These proposed industry-wide changes would amount to a fundamental restructuring of rail regulation and of the rail industry, abandoning well-established regulatory principles and precedents that have served railroads and shippers well since the enactment of the Staggers Act in 1980. These industry-wide open access proposals are beyond the scope of merger policy and beyond the Board's existing regulatory authority under current law.

Moreover, the open access proposals advanced by shippers would do nothing to improve rail service. If applied to any significant body of rail traffic and services (as many commenting parties advocate), they would serve only to drive rates down, far below sustainable levels, precluding railroads from recovering their costs of service. They would transfer needed revenues from railroads to shippers of less competitive traffic -- generally large, economically powerful shippers whose rates are already subject to rate reasonableness regulation. Perhaps

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[33] *Midtec Paper Corp. v. Chicago & North Western Transportation Co.*, 3 I.C.C.2d 171, 179 (1986), *aff'd sub nom. Midtec Paper Corp. v. United States*, 857 F.2d 1487 (D.C. Cir. 1988).

[34] STB No. 41242, *et al.*, *Central Power & Light Co. v. Southern Pacific Transportation Co.* (served Dec. 31, 1996), *aff'd sub nom. MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8th Cir.) *cert. denied*, 120 S. Ct. 372 (1999).

[35] *See, e.g.*, NITL at 11-18; CMA at 11-18; WCTL at 19-22; ARC at 4-7; DOA at 2, 12-17; CURE at 5-6, EEI at 5-6; TFI at 3-6, NGFA at 10-12.

most important, all of these proposals would result in decreased operating efficiency, increased operating costs, impaired service, and diminished investment in infrastructure. Thus, while these proposed policy changes might provide temporary financial windfalls to particular shippers (especially to large shippers), they would condemn the rail industry and the shipping public to a downward spiral of decreased investment and declining service. These pernicious results would occur at the very time when the Board has determined that the "key problem" facing railroads is how to *improve* service to shippers and *increase* investments in infrastructure. ANPR at 3. The open access proposals advanced by shippers would only exacerbate the service problems that have troubled the industry in recent years, and that have received particular emphasis in this proceeding.

In prior cases, the Board and the ICC have rejected efforts by shippers to use rail merger proceedings as occasions to seek enhanced competitive rail service options. As noted in Norfolk Southern's opening comments (at 30-31), the Board recently rejected shipper requests to impose an "open access" merger condition that would have required UP to open the entire Houston terminal switching district to access by other railroads. *See* STB Finance Docket No. 32760 (Sub-No. 26), *Union Pacific Corp. -- Control & Merger -- Southern Pacific Rail Corp. [Houston Gulf Coast Oversight]*, Decision No. 10 (served Dec. 21, 1998) (*"Houston Gulf Coast Oversight"*). In rejecting these requests, the Board clearly stated the economic and legal principles precluding such relief:

> Well-established transportation law recognizes that some shippers are served by a single railroad. . . . Because the railroad industry is not an open access industry, and because some shippers may pay more than others under the law that we administer, merger proceedings are not used as vehicles to equalize the competitive positions of shippers generally. . . . [A] well-established principle of rail

> merger law is that the conditions the Board imposes in a merger proceeding are designed to ameliorate specific merger-related harm, not to simply add more competitors

Houston Gulf Coast Oversight, at 2-3. The Board and ICC have articulated these same limiting principles many other times.[36]

The basic legal and economic principles underlying this policy have not changed in the past 18 months (or in the 20 years since the enactment of the Staggers Act). Nonetheless, shippers have seized on the Board's request for comments on this policy as an invitation to propose a fundamental restructuring of rail regulation. The Board should reject these proposals.[37]

1. Open Access Proposals Are Not Merger Related

The open access proposals advanced by shippers in this proceeding seek to address, and alter, the fact that many, if not most, rail shippers are directly served by only one rail

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[36] *See, e.g.*, STB Finance Docket No. 33388, *CSX Corp. -- Control & Operating Leases - Agreements -- Conrail Inc.*, Decision No. 89 (served July 23, 1998), at 48 ("In evaluating claims of competitive harm, our general practice is to distinguish harm caused by the transaction from disadvantages that other railroads, shippers, or communities may have already been experiencing"), STB Finance Docket No. 33556, *Canadian National Railway Co. -- Control -- Illinois Central Corp.*, Decision No. 37 (served May 25, 1999), at 20 (same), STB Finance Docket No. 32760, *Union Pacific Corp. -- Control & Merger -- Southern Pacific Rail Corp.*, Decision No. 44 (served Aug. 12, 1996), at 100 (same).

[37] The commenting parties that advocate forced or open access measures offer little in the way of new evidence or arguments. The Board and the ICC have heard -- and consistently rejected as unsound -- these same arguments in numerous prior proceedings. Norfolk Southern and the other railroads have frequently submitted testimony and argument refuting the legal and economic basis for such open access proposals. *See, e.g.*, STB Ex Parte No. 575, Comments of the Association of American Railroads (filed Mar. 26, 1998); STB Docket No. 41242, Comments of Association of American Railroads (Oct. 15, 1996); *id.*, Comments and Evidence of Norfolk Southern Corp. (Oct. 15, 1996); *id.*, Rebuttal of the Association of American Railroads (Oct. 25, 1996). Rather than attempt to duplicate this analysis in the short period of time for reply comments in this proceeding, Norfolk Southern (jointly with CSX and UP) is submitting with these reply comments in two separately bound volumes a selection of comments and evidence from prior proceedings addressing these issues.

carrier. These proposals would "create" additional competition for all shippers, whether or not their existing rail service was affected by a merger. They would do so even if a shipper had always been served by a single railroad (which is true for virtually all solely served rail shippers), and even when that shipper's rail service and competitive transportation options would otherwise be unaffected by a merger. They would grant such relief even when a shipper previously had made a conscious decision to locate its facilities on the line of a particular railroad, electing not to position itself to utilize the services of a competing railroad. They would do so even when a shipper has bargained for and received rate concessions or business development assistance from a railroad in exchange for locating its facilities on a particular rail line. And they would impose open access requirements even if the rates paid by shippers are reasonable under controlling maximum rate reasonableness standards and, indeed, even if such rates are below the 180% revenue-variable cost threshold for Board regulatory jurisdiction.

Clearly, the open access proposals advanced in this proceeding are not limited to ameliorating the effects of a particular merger, but are aimed at introducing additional rail-to-rail competition. The fact that a particular shipper traditionally has been served by a single carrier has nothing to do with rail mergers in the past, present or future. This is especially true because, as noted above, the Board and the ICC have taken great care to ensure that shippers are not left "captive" to a single railroad as a result of a rail merger. The market did not support two railroads building in to serve the shipper originally, and generally does not support such two-carrier service today (for otherwise it would have happened). Shippers are thus asking the Board to manufacture rail-to-rail competition that the marketplace itself has not produced and cannot support.

For this reason, as the Board recognized in the *Houston Gulf Coast Oversight* proceeding, there is no principled basis on which to limit shippers' demands for open access conditions or to decide which shippers or locations should be granted access and which should not. As the Board stated:

> The Consensus Plan is premised on the idea that shippers should, wherever possible, be served by more than one railroad . . . . If we adopt the Consensus Plan, then there is no basis on which we could refuse to provide for open access throughout the rail system.

Id. at 2. The Board declined to grant the requested relief precisely because it was not addressed to ameliorating any adverse competitive effect of the UP/SP merger and, for that very reason, there was no principled ground for limiting the proposed open access to particular shippers or, for that matter, to the Houston terminal. Recognizing that open access would threaten rail industry viability and implicate policy issues going far beyond the question of the impacts of the UP/SP merger, the Board properly concluded that the requested open access reform should come (if at all) from Congress, and was beyond the Board's authority.

The advocates of open access in this proceeding effectively confirm that the relief they seek is unrelated to mergers. Many such advocates clearly state that open access conditions (including the various forced access measures outlined in the ANPR) should be extended to *all* shippers and to the entire rail industry, whether or not the points involved are affected by or even involved in a rail merger.[38] Indeed, some proponents assert that it would be unfair and discriminatory for the Board to impose access conditions only on merger applicants, because it would have

[38] *See, e.g.*, ARC at 2, 6; NITL at 12-18; Otter Tail at 6-8; OG&E at 3-4; DuPont at 4-5, 8-9, Dow at 3, 7-8.

the effect of favoring some shippers over others, simply because the railroad serving them is involved in a merger proceeding.[39]

Norfolk Southern agrees that there is no principled limiting factor by which the Board could impose an open access condition for the benefit of some shippers and not others. But that fact simply shows that any attempt to "enhance" competition through an open access condition would go far beyond the Board's acknowledged, legitimate goal of ameliorating any adverse effects of rail mergers. Rather, such an attempt would constitute re-regulation of the rail industry through the "back door" of merger conditions. The Board has previously acknowledged that such re-regulation is beyond its current authority, and that any such radical changes in rail regulation would require legislation.[40] Indeed, recognizing the Board's lack of authority to impose such a radical change in the elements of rail economic regulation, some of the proponents of open access forthrightly called on the Board to seek such authority from Congress.[41] Norfolk Southern does not believe that such legislation is appropriate, but it does agree that the Board has

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39 *See, e.g.*, NITL at 12, PPL at 8-10, Otter Tail at 8, OG&E at 3-4.

40 *See, e.g.*, *Houston Gulf Coast Oversight*, at 2; STB Ex Parte No. 575, *Review of Rail Access & Competition Issues* (served April 17, 1998), at 6 ("[a]lthough access to more routing options could provide additional competition in some circumstances, *the statute does not provide these access remedies on demand; a showing of need is required*") (emphasis added); Letter From STB to Senators John McCain and Kay Bailey Hutchison (dated Dec. 21, 1998) (concluding, based on record developed in STB Ex Parte No. 575, that open-access proposals raise basic policy issues that are more appropriately resolved by Congress rather than the Board). *See also Midtec Paper Corp. v. United States*, 857 F.2d 1487, 1488 (D.C. Cir. 1988) (concluding that agency lacked authority under the Staggers Act to impose a regime of open access: "[w]e have not found even the slightest indication that Congress intended the Commission in this way to conform the industry more closely to a model of perfect competition").

41 *See, e.g.*, ARC at 6; DuPont at 11; Montana Wheat & Barley at 7.

no power to undertake such sweeping re-regulation under current law In any event, the open access proposals advanced by shippers are both unnecessary and unwise, as described below.

2. Open Access Proposals Would Serve No Purpose But To Shift Needed Revenues From Railroads To Selected Shippers

The open access proposals advanced in this proceeding would force railroads to share their privately-owned property with their competitors, permitting their use of these facilities to serve any shipper on demand. Proponents of open access seek to drive rail rates lower by artificially injecting additional competition where market forces have not created it. This is, in essence, an attack on demand-based differential pricing. But differential pricing -- which allows rail carriers to charge less competitive traffic rates reflecting a higher mark-up over variable costs than rates charged to more competitive rail traffic, subject to the Board's maximum rate standards -- is widely accepted as the only practical means for railroads to recover their total costs of service The open access proposals offered in this proceeding would, if applied to any significant body of railroad freight traffic, undermine if not destroy the railroads' ability to engage in differential pricing, thus threatening the financial viability of the rail industry The purpose and effect of these proposals would be to drive rates down below reasonable, sustainable levels, for the sole purpose of transferring revenues from railroads to selected shippers As Professor Baumol explains in his attached testimony, there is no justification for utilizing the rail merger rules to advance this dubious goal.

A number of shippers proposing open access schemes seem to suggest that additional rail competition is needed in order to prevent railroads from charging unreasonably high rates. A close review of these comments, however, shows that these shippers stop short of alleging (much less demonstrating) that the rates they pay are actually unreasonable. The thrust of the complaints by open access proponents is that so-called "captive" shippers pay ***higher*** rates than shippers of dual-served traffic, not that the rates they pay are *too* high. But this is as it should be under the system of demand-based differential pricing that every responsible observer agrees is necessary for a system of efficient, viable rail transportation service. So-called "captive" shippers *must* pay differentially higher rates if the railroad industry is to survive. It is understandable that some shippers which lack direct rail competitive options would prefer not to be burdened with differentially higher rail rates, but if through forced access or other regulatory measures "captive" shippers were entitled to railroad rates with the same average or below-average markups over variable costs that competitive traffic enjoys, the railroads would never be able to cover their full costs, including their huge fixed and common costs.[42]

It is not surprising that commenting shippers have not come forward with any evidence that their rates are unreasonably high. As the Board knows, current regulations provide "captive" shippers, including small shippers, with adequate procedures and remedies to ensure that their rates are reasonable. The Board has not hesitated to apply these procedures to protect captive shippers, and has ordered substantial rate reductions and reparations, as it deemed appropriate, in a number of cases in the past few years. The availability of these procedures, and the Board's recent decisions applying them, also serve to provide a useful benchmark in rate

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[42] Lower prices is a laudable objective, particularly from the standpoint of purchasers. But driving down prices is not invariably a public benefit. For example, invalidating patent protection would surely result in lower prices for prescription drugs, but only at the cost of reduced incentives for research and development and investment in new and better products. So too with the railroad industry, the Board cannot presume that rate reductions for "captive" shippers is without qualification or limitation necessarily a good thing.

negotiations, facilitating private resolution of rate disputes without regulatory intervention. Thus, "captive" shippers have adequate protection from unreasonable rates under the current regulatory framework.

Moreover, there is no suggestion that railroads currently are earning excessive profits or rates of return. To the contrary, most parties agree that railroads need to *increase* revenues and earnings in order to finance additional investments in infrastructure, which in turn will permit improved service to shippers. *See* ANPR at 3. Thus, open access proposals simply are not needed as a substitute for existing rate regulation, either to protect individual shippers or to constrain rail earnings generally.

Given these facts, the open access proposals advanced by various shippers would serve no legitimate purpose, and cannot be justified. The principal effect of these proposals would be to drive down rail rates well below their current levels, and to transfer needed revenues from railroads to selected shippers. Many of these shippers are large, economically powerful companies currently earning rates of return substantially exceeding those of the railroads. There is no justification for modifying current rail regulations for the sole purpose of enriching these companies, while threatening the railroads' ability to maintain and improve the infrastructure needed to provide quality service to all shippers.

Proponents of open access acknowledge that railroads are entitled to compensation for the use of their privately-owned facilities, but they offer no practical means of establishing such charges. If access charges were established at levels sufficient to sustain differential pricing, as they should be, shippers would derive no net benefit from open access. On the other hand, if access charges were established at or near variable cost, differential pricing would be impossible, and railroads would be deprived of any opportunity to recover total costs. This fact is illustrated strikingly in the comments of the Edison Electric Institute ("EEI"), which frankly -- but astonishingly -- asserts that competitive access charges must be set *below total cost* in order to encourage competition. EEI at 5-6 (". . . it may be appropriate to set the switching rate [for EEI's proposed open access switching regime] at a level above variable cost but below total costs if such is necessary to permit competition to continue or to increase to an appropriate level"). EEI does not explain how the railroads could possibly survive if they were forced to provide service at rates below total cost. The answer, of course, is that railroads could not survive under such a regime.[43]

The comments of the U.S. Department of Transportation ("DOT") acknowledge that differential pricing is essential to the financial health of the rail industry. DOT at 12-13 & n.6. Indeed, the economic study commissioned by DOT and referenced in its comments confirms the need for a system of differential pricing, and further demonstrates convincingly that most forced access proposals would preclude railroads from recovering their total costs, and condemn the rail industry to financial failure. DOT, which advocates legislation mandating open terminal

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[43] For similar reasons, other proposals to compensate railroads for forced access fail to address the basic issue of how measures designed to drive rates and revenues down could possibly be consistent with compensatory access. WCTL, for example, proposes a scheme of compulsory trackage rights on demand with compensation to the landlord railroad. WCTL's proposal, however, would compensate the landlord carrier only for the original, historic cost of the railroad assets to which access is granted. WCTL at 20. This conflicts with the established economic principle, which is a fundamental component of the Board's stand-alone cost standard, that railroads must recover rates that reflect the *replacement* cost of assets currently deployed in providing rail service. To use simple terms, a house that was built 100 years ago at a cost of $5,000 but that today has a fair market value of $400,000 would be valued by a competitive market at current, not historic, value. If the owner were forced to accept a rate of return based on the original $5,000 cost, it would never re-invest. But that is exactly what WCTL's proposal would do. The Board should therefore be careful not to accept seemingly benign assertions by shippers that their open access proposals would adequately compensate railroads. By definition, their purpose is to drive rates down.

switching and other open access measures, did not mention these findings by its own retained economist. But the economist's findings support rejection of open access in the railroad industry because it would contradict sound railroad economics and threaten the financial viability of the industry.

3. Open Access Proposals Would Impair Operating Efficiency, Increase Costs And Impede Service

As Norfolk Southern explained in its opening comments, the open access proposals advanced in this proceeding also would significantly impair railroad operating efficiency, increase costs and impede rail service. As the Board knows, railroads have worked tirelessly over the past two decades to improve their operating efficiency, consolidating traffic, increasing traffic density on main lines, eliminating unnecessary switching and interchanges, extending their length of haul, and wringing cost savings from their systems at every opportunity. Shippers have benefitted from these increased efficiencies, both in improved service and in declining rail rates.

Forced access proposals would disrupt existing rail operations in a variety of ways, many of them unpredictable. It can safely be predicted, however, that forcing two railroads to operate over facilities previously used by only one railroad will not necessarily be a cost-free action that results in improved service levels. Norfolk Southern's recent experience in the Conrail Shared Assets Areas confirms this conclusion. Moreover, to the extent that open access produces fewer single-line movements, and more movements in interchange service or switching arrangements, operating efficiency will decline correspondingly. Adding an interchange to a former single-line movement can increase transit times by a day or more, while impairing accountability, frustrating shipment tracing efforts, and increasing total costs significantly.

It is no answer to these concerns to assert that "competition" will magically produce increased operating efficiency. In normal rail operations, market forces provide appropriate incentives for railroads to cooperate in improving operating efficiency wherever possible.[44] Railroads normally work together to establish efficient interchange points and other mutually beneficial operating arrangements. In forced access regimes, however, the normal incentives will be absent or reversed, as the host railroad will have no economic interest in assisting its competitor in achieving operating efficiencies. At best, forced access will result in traffic movements over inefficient routes and interchanges that would never occur if market forces were allowed to work. These inefficient movements can only increase total costs of service, while impeding managerial efforts to improve rail service. Thus, while open access may result in driving rail rates even lower for certain shippers, it will decrease rail revenues, increase total costs, and degrade rail service, all at a time when railroads are struggling to improve operating efficiency and to provide better service to shippers.

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[44] As the testimony of AAR witness Rockey demonstrates, railroads achieved dramatic gains in productivity during the past two decades, and passed these gains on to shippers in the form of lower rates. AAR, Rockey VS. All of this took place without open access, proving that existing competitive constraints and other economic incentives are sufficient to stimulate cost reductions, innovations and efficiency gains. But the principal opportunities for squeezing costs out of the rail system have now largely been exhausted, and it would be unrealistic to assume that -- whatever system of economic regulation is applied to the rail industry -- railroads will continue to achieve the kind of productivity gains that were experienced over the past two decades. It is just as unrealistic to assume that introducing two-carrier rail access for all or any significant group of solely served rail shippers will magically produce significant additional cost reductions that, like a newfound pot of gold, will pay for the rate reductions that open access measures would cause.

4. Forced Access Proposals Would Preclude Additional Investments In Infrastructure

As described above, there is no doubt that the open access proposals offered by shippers in this proceeding would dramatically decrease rail revenues and increase total costs, while impairing operating efficiency and degrading service. Simple math dictates the result of this equation: fewer funds would be available for maintenance of existing rail assets, and further investments in additional infrastructure and improvements would be reduced. Thus, the adoption of any of the open access schemes proposed in this proceeding would produce a downward spiral of decreased investment and degraded service.

Proponents of open access offer simplistic rhetoric about the benefits of competition in general. But these proponents fail to focus on the very real problems that would result from any attempt to impose artificial competition in the rail industry by regulatory fiat. Norfolk Southern embraces competition that is established and supported by genuine market forces. But the open access proposals offered here would fail to establish sustainable competition and would lead to the ruin of the rail industry, to the detriment of railroads and shippers alike.

Norfolk Southern urges the Board to apply sound economic analysis in evaluating the open access proposals before it and to reject these proposals as unnecessary and unwise. But if the Board chooses to adopt an open access proposal that neither compensates railroads adequately for their assets nor permits them to earn sufficient revenues to recover their costs, Norfolk Southern respectfully requests that the Board adopt one more concomitant change in rail regulation: granting railroads the right to exit markets freely if they cannot sustain continued operations. Open access proponents in this proceeding sing the praises of competition and the virtues of competitive markets. But in truly competitive markets, firms that are unable to earn an adequate return on investment are free to exit the market, to redeploy their assets, and to reinvest their capital in markets where they can earn adequate returns. Freedom to enter and to exit is the *sine qua non* of competitive markets. The Board should not adopt a regulatory regime granting unimpeded freedom of entry in rail markets, unless it is prepared to grant the corresponding freedom of exit.

VI. SHORT-LINE AND REGIONAL RAILROAD ISSUES

The opening comments included requests by various parties for new merger rules affording special protections to short-line and regional railroads. In addition to demands for service guarantees and compensation for merger-related service disruptions (an issue that raises essentially the same issues previously discussed), various short-line advocates proposed rules requiring the abrogation of contractual limitations on the interchange of traffic between short-lines and other independent carriers (so-called "paper" and "steel" barriers) and various pricing, access and car supply guarantees.[18]

As Norfolk Southern previously explained, these short-line measures are blatantly protectionist and -- as DOT has noted -- are unrelated to the impacts of rail consolidations. NS Comments at 53-55; DOT at 23-24. There is therefore no conceivable justification for adopting these proposals as requirements for future major rail consolidation proposals. In any event, these proposals (including most elements of the so-called short-line "Bill of Rights" advocated by ASLRRA and supported by some parties) involve longstanding commercial issues between the

[18] *See, e.g.*, ASLRRA at 5-8; MRL at 6-7; Farmrail at 15-29; DME at 6-11; NITL at 20-21; AFPA at 4; WCTL at 22-24; PPL at 24-26; New York at 15-17, Kansas at 15-16; Oklahoma at 4-9.

major railroads and smaller carriers. Some of these issues were addressed in the 1998 Railroad Industry Agreement, and those that were not continue to be the subject of active, productive dialogue. As the Board has previously found, these issues should be resolved through private-sector negotiation and, particularly because they are unrelated to rail mergers, should not be addressed in the Board's revised merger rules.[46]

In particular, there is no justification for adopting rules abrogating existing contractual "paper" barriers on the right of short-line carriers to interchange traffic with other railroads. These restrictions were the product of negotiated contracts that reflected mutually beneficial terms for the sale of rail lines to new short-line operators, and formed an essential component of the overall consideration for the line sale transactions. There is no sound basis for the Board to require rescission of the short-line carriers' solemn contractual obligations as a condition to approval of a proposed major rail merger.

Proposals to ban merging railroads from negotiating any new "paper" (or "steel" barriers), while also unjustified as a remedy for adverse merger impacts, is unsound for a different reason. Such a requirement not only would put the Board in the position of abrogating lawful contracts for reasons unrelated to the effects or necessary implementation of a rail consolidation, but it would discourage major railroads from negotiating favorable terms for future line sale transactions, making it more likely that unprofitable or marginally profitable rail lines would be abandoned rather than sold to new short-line operators. Because no public policy objective

[46] *See* STB Ex Parte 575, *Review of Rail Access & Competition Issues* (served Mar. 2, 1999) (holding in abeyance petition seeking rulemaking to eliminate unreasonable "paper barriers" on ground that it would "quickly overturn a privately negotiated settlement, completed at our direction").

would be served by such a result, the Board should reject proposals to prohibit traffic interchange restrictions in future short-line sale transactions

VII. EMPLOYEE ISSUES

In a proceeding that may well determine the future structure and viability of the U.S. railroad industry, there is nothing to be said for revisiting narrow employee issues that have been litigated again and again before the ICC, the Board, and the courts. Norfolk Southern, the other Class I railroads, the National Railway Labor Conference, and the largest rail labor union, United Transportation Union ("UTU"), have shown that any changes in the Board's longstanding policies and practices respecting employee protection should result from privately negotiated arrangements and corresponding legislation, and that the Board need not and should not take up the matter now.[47]

Against this, other labor organizations (speaking through the Rail Labor Division of the Transportation Trades Department, AFL-CIO ("RLD")) used this occasion to offer their standard employee protection wish list -- including the dismantling of ICA-based procedures for modifying labor agreements, protection against relocation, and attrition protection[48] -- which the

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[47] *See* NS Opening Comments at 55-61, NRLC at 1-27, CN at 30, BNSF at 28-29; CSX at 28-32

[48] In the same category is RLD's proposal (RLD at 25-29) that the Board compel railroads to furnish employees "test period average" ("TPA") data on demand. The ICC recently rejected the contention that an employee is entitled to TPA data prior to a determination that he is a "displaced employee" within the meaning of *New York Dock* Article I, Section 1(b). ICC Finance Docket No. 31922, Sub-No. 1, *Wisconsin Central Ltd. -- Purchase Exemption -- Soo Line Railroad Co. Line Between Superior and Ladysmith, WI (Arbitration Review)* (served April 13, 1995, revised April 18, 1995). This threshold determination depends on whether the employee has been placed in a "worse position" -- that is, a position that pays a lower wage rate -- not whether his aggregate earnings in a given month happen to be lower than his average pre-
(continued...)

ICC and Board consistently have declined to impose in the absence of voluntary agreement. The proposals are transparently opportunistic and owe nothing to the policy concerns that gave rise to this proceeding. There is no argument in favor of the proposition that subjecting future transactions to new or different employee protective conditions or standards would enhance competition, prevent service problems, or otherwise promote any of the objectives that the Board has outlined in this proceeding.[49]

The proposal that employees be permitted to collect monetary benefits without relocating with their work, for instance, has been offered by labor interests -- and rejected by the ICC and the Board -- in nearly all major rail consolidation transactions since the Board's current rail consolidations standards were adopted. The ICC long ago made clear that railroads are permitted to relocate work and employees in order to achieve the public benefits of transactions, and that compensating employees for their economic costs fully satisfies the requirements of the agency's mandate (now codified in 49 U.S.C. § 11326(a)) to impose a "fair arrangement" for the protection of affected employees.[50] More recently, the Board has reaffirmed that an employee's

[48](...continued)
transaction compensation. TPA data are used in measuring the amount of a displacement allowance to which an employee is entitled under Article I, Section 5(a) once he is established to be a "displaced employee"; the data are neither sufficient nor necessary for making that threshold determination. RLD's objective in seeking such data is to assist labor's effort to meld those distinct considerations.

[49] DOT voices the "concern of labor organizations" regarding the ICA-based procedures for modifying labor agreements (what labor calls "cram down") (DOT at 24) and endorses other items on labor's wish list, offering no special perspective on the merits or costs of the proposals or on their implications for broader transportation policy objectives.

[50] *E.g., Norfolk Southern Corp. -- Control -- Norfolk & Western Railway Co.*, 366 I.C.C. 173, 230 (1982); *Wilmington Terminal Railroad Co. -- Purchase and Lease -- CSX Transporta-*
(continued...)

obligation to relocate as a precondition to receiving *New York Dock* monetary benefits is a "basic part of the bargain" embodied in the protective conditions and that the *New York Dock* conditions adequately protect against resulting hardships, "whether the move is a relatively short one or a longer one."[51] RLD does not justify a reexamination of the Board's settled approach by offering new examples of labor's longstanding complaints.

Reopening employee protection issues now would interfere with efforts to reach voluntary agreements. To date, as all commentators acknowledged, the railroads have not been able to reach an agreement with the rail organizations other than UTU. But it would be contrary to everything this Board has said about its preference for private agreements for the Board to step in at this juncture and impose an arrangement. Certainly, it makes no sense for the Board to do what Transportation Communications International Union ("TCU") and other organizations propose -- that is, that the Board take the UTU agreement and load it up with costly enhancements of labor's design. It would be contrary to the letter and spirit of the UTU agreement for the Board to use that agreement as justification for imposing on the railroads terms to which they have not agreed. Indeed, the UTU agreement expressly provides that its terms will not be

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tion, Inc. Lines, 6 I.C.C.2d 960, 963-64 (1990) ("The *New York Dock* conditions themselves contemplate that employees will be relocated as a result of Commission approved transactions. In fact, a key purpose of all the labor protective conditions that the Commission imposes is to provide compensation for such dislocations. ... Thus, it is not extreme or unusual that employees might have to relocate in order to retain their *New York Dock* protection; this is what always has been contemplated under those conditions").

[51] STB Finance Docket No. 33388, *CSX Corp. -- Control & Operating Leases/Agreements -- Conrail Inc.*, Decision No. 89 (served July 23, 1998), at 124; *accord* STB Finance Docket No. 33556, *Canadian National Railway -- Control -- Illinois Central Corp.*, Decision No. 37(served May 25, 1999), at 4.

prescribed as a condition imposed and administered by the Board and that the parties will seek legislation to codify the agreement terms. Moreover, the specific proposal TCU makes here -- which would permit the union to select the applicable labor agreement whenever work is transferred from one location to another -- would render the whole arrangement unworkable. The proposal is so overreaching that it was not even made, much less seriously considered, in negotiations.[52] In all events, these matters are exclusively for negotiations.

VIII. CROSS-BORDER ISSUES

The opening comments raised a variety of concerns about potential cross-border impacts of future major rail consolidation proposals, generally focusing on those involving Canadian railroads, including the extra-territorial application of U.S. safety rules, potential merger-related shifts of traffic from the United States to Canada, national security and defense-readiness issues, possible Canadian government interference in railroad operating practices (including car supply) and pricing, and numerous other issues. Nothing in these comments has persuaded Norfolk Southern to alter its earlier view that all such issues can be dealt with adequately on a case-by-case basis in the context of particular major rail consolidation proposals. In its opening comments, Norfolk Southern suggested that the Board amend its merger rules to require, in cases involving railroads operating outside the United States, the submission of an operating plan and other merger-impact analyses addressing the entire combined rail system,

[52] Under established *New York Dock* standards, as the unions acknowledge (TCU at 12), the labor agreement of the "controlling carrier," that is, the labor agreement in effect at the receiving location, ordinarily applies to work that is transferred from one location on a consolidated rail system to another. Under TCU's proposal, every such transfer, regardless of the relative sizes or scopes of the operations, would present an opportunity for the union to change the existing labor agreement at the receiving location, if not on the entire seniority district or receiving railroad (TCU's proposal seems to leave open either possibility).

including its operations and activities outside the United States. NS Comments at 62-63. Many parties, including DOT and a broad spectrum of railroad and shipper interests made similar proposals.[53] The proposal is eminently sensible for the reasons NS has previously described, and the Board should therefore adopt it.

IX. ENVIRONMENTAL AND SAFETY ISSUES

Notwithstanding the Board's statement in the ANPR that the scope of this rulemaking would not extend to its environmental regulations and procedures (ANPR at 6 & n.15), two commenting parties seek changes in the Board's regulations and procedures pertaining to the assessment of merger-related impacts on the environment and on safety.[54] The Board should adhere to its determination not to address its environmental regulations in this proceeding -- regulations the agency acknowledged do not apply specifically to mergers in any event.

The Board has properly reiterated that rail operation safety concerns are a primary focus of its comprehensive review of environmental issues relevant to railroad merger proceedings. Close cooperation between the Board and the Federal Railroad Administration ("FRA") ensures that safety issues are thoroughly addressed in railroad merger cases. The Board and the FRA have developed an effective inter-agency approach to the formulation and evaluation of Safety Implementation Plans ("SIP's") required of recent rail merger applicants. In addition, as noted in the ANPR, the Board and the FRA have through a recent joint rulemaking proposed a

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[53] *See, e.g.*, UP at 19-21; CSX at 23-25; NITL at 21-22; NGFA at 15-16; Canadian Pulp at 4-5; Weyerhaeuser at 6.

[54] *See* DOT at 27-31; Cleveland at 3-8.

set of federal regulations to address railroad merger safety integration issues in a comprehensive, coordinated manner.[55]

In addition to the joint STB/FRA approach to ensure effective safety integration in merger cases, the Board continues to address other relevant safety issues in the environmental review procedures mandated by 49 C.F.R. § 1105. The Board acknowledged in the ANPR that the process for ensuring that rail safety concerns are given appropriate consideration by the Board works best on a case-by-case basis. Given the unique set of operational and other issues presented by each proposed rail merger, Norfolk Southern concurs with the Board's assessment.

Moreover, the suggestions made by DOT for Board regulation of grade crossing traffic movements and crossing closures would require micro-management of freight traffic flows by the Board, but without the critical benefit of the knowledge of daily changes in traffic conditions available only in the field. As the recent rail traffic difficulties have shown, the smooth operation of a complex rail system requires constant adjustments and well-informed decision-making at all levels. A more complex, restrictive regulatory regimen cannot solve the operations issues that sometimes result in blocked crossings. Norfolk Southern has found that the best way to address such a problem when it occurs is to engage in cooperative discussions with the affected community to determine the cause for the blockage and the most effective solutions.[56]

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[55] *See* STB Ex Parte No. 574, *Regulations on Safety Implementation Plans Governing Railroad Consolidations, Mergers, Acquisitions of Control and Start Up Operations* (served Dec. 24, 1998).

[56] The comments submitted by the City of Cleveland merely repeat many of the arguments made in the recent Conrail control proceeding. As the Board knows, Cleveland negotiated broad-ranging agreements with both Norfolk Southern and CSX that provided the City with a uniquely tailored package of environmental mitigation measures, including significant funding that the city (continued...)

CONCLUSION

For all of the foregoing reasons, the Board should adopt amended major rail consolidation procedures and rules consistent with Norfolk Southern's comments in this proceeding.

Respectfully submitted,

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DATED: June 5, 2000

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[56](...continued)
could at its discretion apply to address many of the very issues Cleveland mentions in its comments, including noise and vibration, emergency response and vehicular delay, grade crossing maintenance and cultural preservation, among other impacts. Any suggestion that the City was not compensated for the range of environmental impacts it believes it has experienced as a result of the Conrail transaction ignores the reality of the comprehensive environmental mitigation packages Cleveland negotiated with Norfolk Southern and CSX.

CERTIFICATE OF SERVICE

I hereby certify that, on this 5th day of June, 2000, I served the foregoing "Reply Comments of Norfolk Southern" by causing a copy thereof to be delivered by first-class mail, postage prepaid, to each of the persons listed on the Board's official service list in this proceeding.

Vincent F. Prada

Vincent F. Prada

ATTACHMENT A

VERIFIED STATEMENT

OF

WILLIAM J. BAUMOL

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

VERIFIED STATEMENT

OF

WILLIAM J. BAUMOL

Qualifications

My name is William J. Baumol. I reside at 45 Ocean Avenue, Monmouth Beach, New Jersey, 07750, USA. I am professor of economics and Director of the C.V. Starr Center for Applied Economics at New York University. I received my bachelor's degree in economics from the College of the City of New York in 1942 and my Ph.D. from the University of London in 1949. After my military service in Europe during World War II, I taught at the London School of Economics from 1947 through 1949. I then served as a member of the faculty of Princeton University for 42 years, where I recently became professor emeritus, and where I still hold an appointment as Senior Research Economist. I have written approximately 30 professional books and 500 articles. I have served as president of four leading professional organizations of economists including the American Economic Association, the world's largest organization of economists from business, government, colleges and universities. I hold nine honorary degrees and other honors in the United States and abroad, and am a member of three of the nation's leading honorific societies, including the National Academy of Science.

I have taught university courses on the economics of antitrust, regulation and industrial organization, and have been invited to lecture on these subjects in forums throughout the world, most recently in Australia, France, Israel, Italy, England and Venezuela. I have also written a number of articles and books related to these subjects and have testified extensively on antitrust and regulatory issues before courts and regulatory agencies in the United States and abroad. Over almost forty years, I have been involved in matters relating to regulation of railroads in the United States.

The Issue and My Conclusions

The Board's request in Ex Parte No. 582 for comments on the appropriate rules governing future Class I mergers has been seized upon by some of the largest and most affluent shippers and their trade associations (henceforth I will refer to them as "the Access-Seeking Shippers") as an opportunity to re-impose regulations of railroad rates that are designed in the spirit of the pre-Staggers era. I address in this statement proposals by a number of parties that the Board adopt rules compelling merging railroads (and in some cases even non-merging railroads) to provide competing railroads with access to their exclusively-served shipper facilities, via mandatory switching in terminal areas, grants of trackage rights, or requirements to establish separate challengeable rates for existing bottleneck segments. I will refer to all of these proposals as seeking "forced access."

Those who advocate the forced access rules make little effort to conceal their objective -- the imposition of regulations that would lead directly to lower transportation fees that, in turn, would result in further erosion of the railroads' persistently inadequate earnings. They ignore the inevitable effect in terms of deterioration of the rail network, and the resulting undermining of service quality and service provision. They repeatedly claim that their objective is to enhance competition and to turn to the market rather than to regulation as the determinant of railroad decisions and activities, when they demonstrably mean the opposite. They repeatedly refer to railroad "monopoly profits" when they know full well that railroad rates of return persistently fall below the levels earned in the economy's other industries, many of which are manifestly competitive and subject to the control of the unconstrained market.

Decades of ill-advised regulation and the persistent inadequacy of rail revenues, for which regulation bore heavy responsibility, led to drastic under-investment in the rail network. While the Staggers Act of 1980 had a beneficial effect on infrastructure investment, further improvement in the rail network has manifestly been held back by the inadequacy of railroad earnings. The shippers who are participating in this rulemaking and using the merger issue as an excuse to advocate re-regulation through regulatory intervention apparently do not recognize that the changes they propose must in the long run be damaging to all or virtually all those affected, *including themselves*.

The forced access proposals appear to promise stimulation of competition by the imposition of access, on what amounts to uncompensatory terms, to the properties of the railroads. But this will simply constitute a subsidy of competitors regardless of their efficiency and a transfer of funds from the railroads to the shipper proponents of forced access. It will be a tilting of the playing field that undermines competition, while having the appearance of promoting it.

It has been argued that imposed access will help to prevent breakdowns in service quality by giving others access to a railroad's bottleneck facilities, with rival carriers striving for business through improved service quality. But those who argue this way do not realize that their remedy can only bring on the disease it is ostensibly designed to cure. By further undermining efforts to achieve adequacy of revenues, the proposed changes will prevent the railroads from obtaining the funds for the very investments needed to prevent service deterioration. And after rail operation is turned into an activity whose earnings are even further behind those of U.S. industry generally, who will really want to compete for the privilege of carrying even more money-losing traffic?

The Competitive Capital Markets and the Importance *to the Economy* of Adequate Rail Earnings

Avoidance of regulatory imposition of access requirements that will inevitably lead to inadequate railroad earnings is not simply a matter of legal requirements and justice in the treatment of investors. Rather, the economy itself stands to lose an essential part of its infrastructure if indefensible reregulation further reduces railroad earnings. The economy's capital markets are highly competitive, and investors are under no compulsion to provide financial resources to any enterprise that does not promise a level of earnings commensurate with those currently offered by others who are in the market for funds. That is why adequacy of earnings in any industry, from the viewpoint of economic efficiency, is only legitimately measured by reference to the earnings currently obtained in other industries. And in these terms it is easy to demonstrate that while rail earnings have improved since adoption of the Staggers Act, they have nevertheless remained persistently and substantially below adequate levels.

Experience in rail transportation in the wake of the Staggers Act should convincingly demonstrate that in this industry achievement of adequate revenues is no easy matter. The governing statute enjoins regulators to refrain from measures that prevent the achievement of adequacy of earnings by the railroads. Regulators, indeed, have clearly tried to live up to this admonition. And, in fact, in the post-Staggers era, the railroads have progressed markedly toward the goal of adequate revenues, doing so, it should be noted, with the aid of steadily *declining* real rail rates. *But the fact is that rail earnings remain well below those of most other industries.* So long as the railroads remain unable to offer investors returns as attractive as those investors can obtain elsewhere, they will be severely constrained in their ability to obtain the investment resources they need to serve those who now demand imposed access, as well as others. In other words, in the pertinent sense of the term, rail revenues must be deemed to continue to be inadequate.

This means that investors can be relied upon to vote with their feet. That is, if rail revenues are cut further investors may well refuse to provide railroads with the funds necessary for maintenance, replacement, modernization and (where needed) expansion. Alternatively, the investors will supply funds only on terms that are unsustainable from rail earnings alone and can only be financed by, in effect, giving away the railroads' assets. Moreover, if measures are taken that will further reduce these revenues it will clearly be management's responsibility to investors to refrain from pouring good resources after bad and to seek, on the contrary, to reduce the resources tied up in rail investment.

The effect on rail service should be obvious. The damage will be felt most severely by the shippers located on the less heavily utilized portions of the network that would be the first, but not necessarily the last, casualties of inadequate investment. These (usually smaller) shippers, in contrast, by and large, are not directly represented in this proceeding but with whose interests the large Access-Seeking Shippers are ostensibly concerned. However, even though smaller shippers may suffer first, in the long run even these large shippers will bear the consequences of their proposals, and the resulting deterioration in the amount and quality of service that the railroads will be able to provide to them will, so to speak, constitute the punishment that fits the crime.

How to Ensure Continued Inadequacy of Railroad Returns

The proposals of the Access-Seeking Shippers are clearly likely to make it impossible for the railroads to recover their substantial sunk, fixed and common costs. The proponents of forced access seek access in order to reduce the total amount they pay for transportation, and thereby to reduce the revenue contribution that an incumbent can receive from its ownership of a bottleneck facility. But in a market where competition limits the price railroads can charge for most of their traffic, any artificial reduction in the revenues obtained from movements for which regulation provides the upper bound on rates simply must reduce the railroads' total revenues. Stated differently, on fully competitive sections of a route rivalry forces rates downward toward variable costs because any supplier will be unwilling to forego a contribution to its fixed and common costs, however small. So from these segments only a minor portion of those costs can be recovered, leaving the rest to be obtained from the bottleneck portions of the route -- the only place they are available. The regulatory ceiling on end-to-end rates then ensures that no more than the appropriate amount is recovered from the bottlenecks. Thus, forced access in the railroad industry -- which by definition would undermine railroads' ability to price differentially -- could not be more threatening to the prospects for adequacy of railroad investment.

The railroads, like other industries, must obtain revenues not only sufficient to cover their variable or incremental costs, but also their extensive fixed and common costs, notably the costs of track maintenance and improvement. If the forces of competition prevent the earning of more than variable costs on the non-bottleneck portion of a railroad's facilities, it is only through its earnings on bottleneck facilities that it can hope to cover its fixed and common costs. The calls for imposed competitive access at regulated prices for bottleneck service are thus a direct challenge to differential pricing. Differential pricing is uniformly acknowledged to be a critical requirement for financial viability of the railroad industry. This is a direct consequence of the fundamental economics of railroading, with its high fixed and common costs and the presence of competition in most of the network. The shippers generally do not challenge differential pricing openly, since its logic and reasonableness are so widely recognized. Instead, they call for price ceilings on the portions of the railroads' services where fixed and common costs can be recovered. These ceilings are tantamount to the elimination or the imposition of severe constraints upon differential pricing, preventing continued recovery (with no excess profits) of any of the railroads' fixed and common costs.

In sum, despite the rational regulatory policies under which railroads now operate, they have for many decades been unable to achieve rates of return anywhere near those of the many other industries with which they compete for investment funds. It is little short of a miracle that, despite this, in the post-Staggers era the railroads have been able to carry out as much investment as they have. Looked at from the point of view of investor incentives, it should hardly be surprising that there have been some breakdowns of service quality. The surprise, rather, should be that despite persistently substandard rates of return, service and capacity problems have been so rare.

Will Competition Really Be Promoted By Forced Access To Bottleneck Services At Uncompensatory Rates?

Ironically, one point repeatedly made by Access-Seeking Shippers is that their aim is to substitute market discipline for regulation as the means to constrain the behavior and decisions of the railroads. The Access-Seeking Shippers do, indeed, emphasize their dedication to substitution of market forces for regulation. Thus, for example, in the Opening Comment of PPL Electric Utilities Corporation and PPL Montana LLC, "major benefits" are ascribed to "an approach emphasizing market discipline, in contrast to public utility-style ratemaking..." (pages 15-16). Yet the Comments submitted by The Fertilizer Institute refer to "the possibility of requiring merger applicants to provide switching at an agreed-upon fee", noting that "TFI supports this change." (page 4). Similarly, the comments of Dow Chemical Company tell us that "Dow encourages the Board to consider [permitting shippers] to apply to the regulatory agency to set a rate for traffic over the bottleneck railroad serving the shipper to an interchange point with another railroad." (page 8). This is indeed a desire for deregulation through reregulation.

Far from creating marketplace competition where there is none today, the kind of forced access requirements that are proposed in this proceeding would subsidize the entry of less efficient railroads. New entry via forced access under these conditions would not result in any *real* addition to competition in the industry. Clearly, with inadequate returns to the industry, no one is about to construct new competitor rail lines, particularly under the proposed new rules that would further reduce earnings opportunities. Unlike the entry of new electricity generators who bring new facilities with them or the development of new gas fields that were previously untapped, imposed access in the rail industry is not even *intended* to lead to construction of new railroad lines or new facilities in bottleneck areas. Also, there is no major new railroad technology or new low-cost operating technique whose utilization would be promoted by forced access. Nor would these rules lead to the entry of new barge lines or trucks that are a prime source of competition in surface transportation.

What type of new entry is, then, sought by proponents of imposed access in the railroad industry? It is forced, subsidized entry that, wholly apart from its devastating effects on the earnings of the incumbent railroads, would lead to inefficient results that would never persist in any effectively competitive market.

Under the existing regulatory regime, bottleneck rates are not unconstrained. Under the existing rate reasonableness regime, railroads are prevented from earning too much through their bottleneck facilities under the principles of Constrained Market Pricing, which prevent the railroads from charging origin-to-destination rates, *inclusive of service on the bottleneck portions of their service,* that exceed competitive standards. The basic reason for placement of a ceiling only on end-to-end rates is straightforward. That end-to-end rate is the amount the customer actually pays, and it is what should matter for the shipper who is dedicated to the competitive market model for rate regulation. Under these circumstances, a change in the price of a component is as irrelevant as a change in the sticker price of an automobile transmission, when the price of the automobile remains fixed at $20,000. Or rather, it remains irrelevant unless an association of auto transmission repair shops persuades regulators to place a $10 ceiling on the price of transmissions and then demands that the car manufacturer supply the shops with transmissions alone, at their newly regulated price. That is precisely what the shippers are after here. They seek to impose uncompensatory price ceilings on bottleneck service in isolation, patently planning to purchase bargain bottleneck service and no more from the affected railroads.

Under current origin-to-destination regulation of railroad rates based on the competitive market model, the owner of a bottleneck facility has strong incentives to let a more-efficient provider handle traffic that moves over the bottleneck at a compensatory fee beneficial to both parties. The owner of the bottleneck can maximize its net revenue from the origin-to-destination movement only by avoiding any wasted costs that it might incur by handling the traffic itself, if another carrier can do so more efficiently. Therefore, as in any competitive market, the bottleneck owner has the incentive to make efficient "make or buy" decisions -- *i.e.*, to provide the service itself if it can do so efficiently, or to "buy" the service from a more efficient supplier.

Two conclusions follow from this discussion. First, if regulators set an access charge for the bottleneck alone -- *i.e.*, a switching fee the carrier may not exceed when it provides compulsory switching to the exclusively-served plant, a trackage rights charge the carrier may not exceed when it is forced to allow the competitor to operate over its lines to serve the exclusively-served shipper, or the rate factor it may not exceed when it is compelled to set a separate rate for the bottleneck segment -- below the level called for by the competitive market model, it would not increase competition, but simply would amount to a cross-subsidy that allows less efficient providers to take business away from a more efficient competitor. Second, if regulators set access charges at a level that *does not* distort competition between the bottleneck owner and its competitors, a forced access regime would not result in any changes in the way traffic is handled today. The current regime already gives the owner of a bottleneck facility the incentive to lease the facility to a competitor railroad if the other railroad can handle the traffic more efficiently and can therefore produce higher net revenues from the bottleneck service than the bottleneck owner can by itself. Forced access would merely create another complex layer of regulation that, if carried out in accord with the competitive model, essentially would arrive at the same result. It would make no difference to the competitiveness of the industry.

Forced access would also increase operating costs by making it difficult for a railroad to achieve economies of density. One of the most important characteristics of the railroad industry is that, up to a point, an increase in the volume of traffic over a line or through a yard decreases the per unit cost of the traffic. Higher traffic densities also permit more efficient use of resources, since it requires at least a minimal number of management and operating personnel, equipment, tracks and related facilities to move even a small volume of traffic in a particular area. If two carriers split the traffic, it is likely to require a net increase in the number of crews, locomotive power and freight cars to provide the previous quality and quantity of service.

Forced access would also undermine efficiency in decisions on investment and scheduling needed to accommodate different types of traffic. Not only must a railroad ensure that a particular car moves from its origin to its designated destination, but it must coordinate the movement of several types of traffic with different characteristics. The same segment of a rail line may be used to handle traffic with different time sensitivity, different operating characteristics, and different prices. Fast intermodal trains must be handled differently from high-volume unit coal trains. It is necessary for railroad management to coordinate marketing, operating and investment decisions if it is to achieve anything like an optimal mix of these traffic types along with the most efficient allocation of the required resources. Forced access would make it more difficult to reach and carry out efficient decisions on coordination of these different traffic types.

All of this strongly suggests that the real objective of the proponents of forced access is to achieve reductions in railroad rates through inappropriate regulation of the access charges, not to obtain any real increase in competition. They apparently do not realize or do not care that in the long run this can only lead to deterioration of the rail network and ultimately to loss of service meeting the standards that these shippers themselves require.

The Imposition of Various Forms of "Forced Access" In Other Industries Does Not Support Such Rules In the Railroad Industry

It has been argued that the recent measures imposing access in several other regulated industries demonstrates the feasibility and wisdom of similar measures for railroad freight transportation. But circumstances in those other industries differ markedly from those of the railroads, and those differences mean that the access measures appropriate elsewhere are totally inappropriate for the railroads. There are at least four important and relevant ways in which the electric power, telecommunications and natural gas industries differ from the railroads. First, the economic and regulatory conditions that prompted access regulation in the other industries simply do not exist in the railroad industry. In the three supposedly similar industries, because there is no full end-to-end regulation of rates, failure to impose access threatened to preserve or provide monopoly power to some of its firms and could serve as a significant incentive for self-favoring discriminatory behavior. In railroading, the rules limiting end-to-end charges under the regime of Constrained Market Pricing already provide an effective shield against such problems.

Second, access regulation in the other industries was intended to promote the entry of new competitors and to expand competitive options at a time that new technology and low-cost suppliers were becoming increasingly available. Without access regulation, the owners of the monopoly facilities could discourage or prevent the new entry from occurring. In the railroad industry, forced access to bottleneck facilities does not promise to provide any entry by new rival enterprises.

Third, in the other industries, freedom of access to bottleneck facilities does not impose difficult and costly coordination problems for efficient handling of the activities and outputs of the firms to which access has been granted. In the case of the railroads this is markedly not true, and coordination of trains and cars traversing the same bottleneck but controlled by different firms would clearly be a complex and costly requirement. Since access promises no competitive benefits to offset these costs, the result would be a net loss in public welfare.

Fourth, access in the railroad industry would seriously jeopardize the ability of railroads ever to achieve revenue adequacy, a risk that also arises, but is not nearly as serious in the other industries.

While this is not the place to discuss why required access was, indeed, highly appropriate in at least some of these other industries, it should be clear that this is no justification for the adoption of similar measures in the rail arena.

The Competitive Model as Guide for Public Interest Regulation

A principle almost universally applauded, but all too often honored only in the breach, is that regulatory rules should serve as a substitute for competition in arenas where competition is difficult to sustain. This means that it is the duty of regulators to require the firms they oversee to behave as they would if their activities were carried out in a competitive marketplace. But this guiding principle also means that regulatory intervention must go no further. It must not force firms to adopt measures that they would not have to accept in a fully competitive market. Experience repeatedly confirms that well intentioned but misguided attempts to constrain pricing, investment and other related activities of firms more severely than they would be by competitive forces introduces inefficiencies that raise costs, degrade service and infrastructure and seriously damage the public welfare.

The rationale for these conclusions is provided by systematic economic analysis as well as by extensive experience. Economics has repeatedly demonstrated that competitive markets lead to economic efficiency, precluding waste, excessive costs and outputs that are not guided by consumer demands. Competitive markets yield prices that reflect the low costs made possible by efficiency and which provide no excessive profits. Moreover, the prices that emerge in such markets can be shown to provide the right incentives for production to be carried out by the most efficient suppliers in the most efficient way currently possible. In short, the competitive market model is an appropriate guide for regulation because there is no known economic arrangement that serves the public's economic interests more efficiently and effectively.

All this, in turn, has several clear implications:

1. Regulators should never intervene where competition is already reasonably effective.
2. All relevant market constraints, including modal, geographic and product competition, must be considered in analyzing the effectiveness of competition for particular railroad prices and services. If railroad pricing and service is effectively constrained by these forces, regulation has no role. It does not matter whether those constraints are provided by railroads with parallel routes or by geographic or intermodal rivalry, as long as the resulting constraints on behavior are sufficiently powerful to prevent monopoly prices and profits and to preclude inefficiency.

3. Since regulation should never force firms to do what they would not accept in a competitive market, rules that threaten to drive their earnings below a competitive level should never be adopted.

4. The obvious consequence of violation of the preceding principle is inadequacy of investment and deterioration of service and infrastructure. No law can force investors to provide resources to an industry that only offers losses to those investors, or whose returns are lower than the returns investors can obtain in other markets.

5. In competitive markets firms often offer access to their facilities to others, including competitors. But they do so only after voluntary negotiation elicits a price that makes it profitable for the owner of the facilities to permit such access.

6. The preceding observations, and particularly the principle that regulated firms should never be forced to do anything they would not do in a competitive market, has several direct implications. First, it indicates that access will be granted voluntarily only if the price is adequate. Firms in competitive markets will not grant voluntary access at inadequate prices. Second, it follows that enforced access, in violation of the competitive market model for regulation, is likely to be a source of inefficiency, inadequate earnings and degradation of service.

7. It will surely be argued that enforced access is immune from these objections because it is a means to introduce competition, rather than a way of evading competitive guidelines. However, if the price of access is set below the competitive level, that is, below the level that would induce access to be provided voluntarily in a competitive market, the result must in effect be subsidized entry. Such entry terms permit inefficient entrants to destroy

incumbents, not by virtue of the entrant's superior performance, but through the special financial advantages conferred upon it.

8. In sum, as is recognized by all those who have carefully analyzed the issue, while such subsidized entry has the spurious appearance of enhancing competition, such entry really threatens to undermine both performance and true competition.

This completes our brief review of the logic of the competitive market model for regulation and its implications for the access proposals at issue here. The main conclusion that emerges is that enforcement of access -- except on terms that would lead the incumbent to grant access voluntarily in a competitive market -- is likely to impede or even destroy competition, despite the spurious appearance of such measures as instruments for the promotion of competition.

The Likely Consequences of Imposed Access: Undermined Investment, Increased Coordination Cost and Enhanced Litigation

We can now sum up the implications of our analysis. Legislatively imposed access is currently advocated with the claim that it will enhance competition, increase investment and improve service quality. We have seen that the reality is very different.

Even more to the point, forced access is virtually certain to exacerbate the low-earnings problems of the railroads and thus to handicap them further in their investment efforts. The experience of the decades before the Staggers Act demonstrates clearly and dramatically to what depths railroad investment and quality of service can be driven by such developments. Yet, such a scenario is precisely what is being offered by the proponents of imposed access rules. It is ironic that this undermining of infrastructure is the predictable result of proposals allegedly offered in part to prevent breakdown of service quality. And it is equally ironic that the proposals are offered as a means to attract competition, while they really threaten further reductions in the already inadequate revenues that are a prime disincentive for enhancement of competitive activity.

We have seen that the proposal also threatens to increase costs by contributing to the complexity of coordination of the traffic introduced by imposed access. It also threatens to increase costs by adding new and unnecessary layers of regulation and encouraging litigation.

There is only one credible explanation for the advocacy of imposed access. Its proponents can only be hoping to obtain a legislatively mandated bargain price for the services they get from the railroads whose facilities they want to use. They seek to obtain a price below that which would prevail in an unregulated market. They are hoping that the Board will, in fact, force the railroads to provide them with subsidies. But that makes no sense even in terms of the self-interest of those advocates. Clearly, these proponents of imposed access need the services of the railroads, and they need those services to be provided efficiently and expeditiously. There is no better way to ensure that those needs will *not* be met than to take steps that further handicap the railroads' investment efforts, by driving them still more behind prevailing earning standards in the U.S. economy

VERIFICATION

I, William J. Baumol, declare under penalty of perjury that the foregoing statement is true and correct. Further, I certify that I am qualified and authorized to file this statement. Executed on June 2, 2000.

William J. Baumol